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COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

BACKGROUND DATA AND READINGS ON THE BUDGET DEFICIT, THE STATUS OF THE U.S. ECONOMY, AND FEDERAL BUDGET POLICY FOR FISCAL YEAR 1990 AND BEYOND

[For Hearings To Be Held on February 7, 8, and 9, 1989]

FEBRUARY 6, 1989

Prepared for the use of the Committee on Ways and Means by its staff

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DESCRIPTION OF BUDGET TABLES

Overview

The following tables and charts are compiled from a variety of Congressional Budget Office (CBO) and Office of Management and Budget (OMB) publications as well as Departments of Treasury and Health and Human Resources documents. The first nine tables present CBO and OMB baseline estimates for the next five fiscal years, compare economic assumptions between CBO and OMB, and present the budget proposals of the Reagan Administration by major spending category and by provision for programs within the jurisdiction of the Committee on Ways and Means. The next five tables present historical data on trends in outlays with particular emphasis on programs within the jurisdiction of Committee on Ways and Means. The next two tables present information on revenues. The last table presents information on net savings and investment flows.

Each year, as CBO receives information from the Administration it revises the baseline estimates printed in "The Economic and Budget Outlook" publications. This year was no different and as a result outlays and the deficit increased by $5 billion in 1990, $6 billion in 1991, and by $8 billion in fiscal year 1994. Not all tables were revised. The tables from the January 1989 report are labeled as the January CBO baseline and the latest set of numbers are labeled "revised".

Table 1 (Revised Estimates)

Table 1 compares CBO and OMB projections of baseline revenues, outlays and deficits. In general, these baseline projections assume that revenue and entitlement law are unchanged, that expiring provisions do indeed expire, and for discretionary programs it is assumed that budget authority is increased to reflect inflation. For fiscal year 1990, CBO projects a baseline deficit of $146 billion while OMB projects a deficit for $127 billion, approximately $20 billion less.

Without any change in law, OMB projects the deficit will fall to $9 billion by 1994 while CBO projects a small decline in the deficit. The primary reason for these differences is the economic assumptions, primarily the interest rate assumption. As shown in Table 2, OMB projects an interest rate of 3.0 percent in 1994 while CBO assumes an interest rate of 5.9 percent.

Table 2

Table 2 compares Administration and CBO economic assumptions, by calendar year. As noted above these difference in the economic assumptions are the primary reason the baseline deficit projections are so different between CBO and OMB.

Table 3

Table 3 compares administration, CBO, and Blue Chip short-run economic forecasts.

Table 4

Table 4 presents rules of thumb which illustrate the impact on revenues, outlays, and deficit projections if the economic assumptions assumed in the baseline do not materialize. For example, the first panel illustrates that if real growth were 1 percent lower beginning in January 1989 the deficit projection for fiscal year 1990 would be $24 billion higher. The fourth panel indicates a similar effect for a 1 percentage point increase in interest rates. Thus, a 2 percentage point change in the interest rates compared to the baseline assumption would increase the deficit in fiscal year 1990 by $22 billion. These same rules of thumb, in rough terms apply to OMB projections.

Table 5

Table 5 illustrates the trust fund surpluses in the January CBO baseline. In fiscal year 1990 the trust funds have an annual surplus of $135 billion. This increases to $179 billion by 1994. The rest of the budget has a deficit of $276 billion in fiscal year 1990 which increases to $301 billion by 1994. These numbers will change slightly as a result of the revisions to the CBO baseline.

Table 6

Table 6 compares CBO and OMB estimates of the Reagan Administration's budget proposals. OMB projects that if all the Reagan Administration's budget proposals were enacted, the deficit would decline to $93 billion in fiscal year 1990 and the unified budget deficit would show a surplus of $33 billion in fiscal year 1994. CBO projects that even if all the Reagan Administration budget proposals were enacted, the deficit in fiscal year 1990 would be $120 billion, some $20 billion higher than the Gramm-Rudman-Hollings deficit target. By 1994, if all proposals were enacted the deficit is projected to decline to $65 billion.

Table 7

Table 7 illustrates OMB estimates of spending changes by major category. Defense spending is to increase by $2.1 billion over current services. Non-defense discretionary is to be reduced by $4.3 billion, entitlements are to be reduced by $18.0 billion, and revenues are to be increased by $13.1 billion. Only a small portion of the $13.1 billion of revenue increases are within the jurisdiction of the Committee on Ways and Means. The Medicare reductions include both legislative and regulatory changes.

Table 8

Table 8 illustrates preliminary estimates by the Administration for budget proposals affecting the programs within the jurisdiction of the Committee on Ways and Means. Medicare legislative proposals are projected to reduce outlays by $4.9 billion in fiscal year 1990 increasing to $16.5 billion by fiscal year 1994. The Reagan Administration also proposed to end the Trade Adjustment Program for a total savings of $1.2 billion over the next five years. Proposals within the Subcommittee on Human Resources will reduce outlays by $415 million in fiscal year 1990 and by $2.3 billion over the next five years. Revenues are increased by $400 million in fiscal year 1990 and by approximately $1.4 billion in fiscal year 1994.

Table 9

Table 9 compares the Reagan Administration budget proposals to sequestration assuming an OMB deficit projection of $126 billion. Defense programs would receive a $13 billion outlay reduction under sequestration compared to a $2.1 billion increase under the Reagan budget proposals. Non-defense discretionary programs would receive a $10.7 billion reduction and a $4.3 billion reduction under the Reagan budget proposals. Entitlements would be reduced approximately $2.5 billion under sequestration (of which $1.5 billion is Medicare) compared to $18 billion under the Reagan budget proposals. There are no revenue increases under sequestration. These discretionary program reductions are from a baseline that assumes budget authority has been increased for inflation.

Table 10

Table 10 presents outlays for major spending categories for selected years in nominal dollars and as a percent of Gross National Product (GNP). The last column illustrates the average annual growth rate between 1985 and 1994. Medicare outlays increase at an annual rate of 11.1 percent compared to total budget expenditure growth of 5.1 percent.

Chart 1

Chart 1 illustrates the numbers in Table 10 in chart form.

Table 11

Table 11 illustrates the increases in spending if government expenditures in major categories had been increased for prices and population. This table blindly assumes that spending should stay the same in real per capita terms. The methodology does not take into account medical price increases different from inflation, it does not account for defense policy needs nor account for the fact that some programs serve populations growing faster than average.

The price index chosen in this blind methodology is the GNP deflator. This table is primarily designed to illustrate which major spending programs are growing faster than prices and population and which categories are growing more slowly.

If 1980 is chosen as a base year, defense spending would have grown to $274 billion in fiscal year 1994 compared to $356 billion in the January CBO baseline. This is a difference of $82 billion as illustrated in the last column of the table. Medicare spending under these blind assumptions would have increased to $69 billion in 1994 compared to the CBO estimate of $180 billion. Non-defense discretionary spending shows a completely different result. If expenditures had been adjusted for prices and population, non-defense discretionary spending would have been $87 billion more than is projected in the CBO baseline for 1994. The second half of this table shows somewhat different results using 1985 as the base year.

Table 12

Table 12 shows CBO January baseline projections for programs within the jurisdiction of the Committee on Ways and Means.

Table 13 (Revised)

Table 13 shows CBO revised baseline projections for entitlements and other mandatory spending categories.

Table 14

Table 14 presents similar information for selected historical years.

Table 15

Table 15 presents total federal revenues in nominal dollars and as a percentage of GNP from fiscal years 1988 to 1994 in the January CBO baseline.

Table 16

Table 16 presents the same information for selected historical years.

Table 17

Table 17 presents net savings and investment flows as a percentage of GNP. This table shows that net domestic savings shortfalls (primarily a result of the federal deficit and declines in net private domestic savings) have been met by capital inflows from abroad. These have grown from zero in 1982 to 3.4 percent in 1987 and has fallen to 2.4 percent in 1988.

Table 1. - CBO AND OMB BASELINE ESTIMATES (CURRENT SERVICES)
(fiscal year, in billions of dollars)

	1989	1990	1991	1992	1993	1994
Revenues						
CBO	983	1069	1140	1209	1280	1359
OMB	976	1058	1137	1209	1278	1342
Outlays						
CBO	1142	1215	1287	1348	1416	1489
OMB	1136	1185	1238	1278	1315	1350
Deficit or Surplus						
CBO	-159	-146	-146	-140	-135	-130
OMB	-160	-127	-102	-70	-37	-9
Deficit Targets	-136	-100	-64	-28	0	.....
as a percentage of GNP						
Revenues						
CBO	19.2	19.6	19.6	19.5	19.5	19.4
OMB	19.1	19.3	19.4	19.5	19.5	19.5
Outlays						
CBO	22.3	22.3	22.1	21.8	21.5	21.2
OMB	22.2	21.6	21.2	20.6	20.1	19.6
Deficit or Surplus						
CBO	3.1	2.7	2.5	2.3	2.1	1.9
OMB	3.1	2.3	1.7	1.1	0.6	0.1

Note: Totals include Social Security, which is off-budget.

Sources: Congressional Budget Office; Office of Management and Budget.

TABLE 2. COMPARISON OF ADMINISTRATION AND CBO ECONOMIC ASSUMPTIONS, 1989-1994 (By calendar year)

	Estimated	Forecast		Projected			
	1988	1989	1990	1991	1992	1993	1994
Nominal GNP (Billions of dollars)							
Administration	4,857	5,211	5,570	5,939	6,296	6,640	6,968
CBO	4,859	5,209	5,542	5,902	6,281	6,685	7,117
Real GNP (Percent change, year over year)							
Administration	3.8	3.2	3.2	3.3	3.2	3.2	3.2
CBO	3.8	2.9	2.1	2.2	2.2	2.3	2.3
Consumer Price Index[a] (Percent change, year over year)							
Administration	4.0	3.8	3.7	3.2	2.7	2.2	1.7
CBO	4.0	4.9	4.9	4.6	4.4	4.4	4.4
GNP Deflator (Percent change, year over year)							
Administration	3.4	3.9	3.6	3.2	2.7	2.2	1.7
CBO	3.4	4.2	4.2	4.2	4.1	4.1	4.1
Three-Month Treasury Bill Rate (Percent)							
Administration	6.7	6.3	5.5	4.5	4.0	3.5	3.0
CBO	6.7	7.9	7.1	6.7	6.4	6.1	5.9
Ten-Year Government Note Rate (Percent)							
Administration	8.9	8.3	7.2	6.0	5.0	4.5	4.0
CBO	8.9	9.3	9.0	8.6	8.1	7.7	7.4
Unemployment Rate[b]							
Administration	5.4	5.2	5.1	5.0	5.0	5.0	5.0
CBO	5.5	5.5	5.5	5.5	5.6	5.6	5.6
Tax Bases							
Wage and salary disbursements							
Administration	2,434	2,605	2,780	2,969	3,159	3,342	3,515
CBO	2,435	2,615	2,787	2,969	3,163	3,370	3,590
Other personal income[c]							
Administration	1,618	1,721	1,853	1,955	2,043	2,119	2,204
CBO	1,626	1,754	1,870	1,977	2,090	2,211	2,346
Corporate profits[d]							
Administration	301	351	396	442	475	498	522
CBO	299	328	351	378	390	401	424

SOURCES: Congressional Budget Office; Office of Management and Budget.

a. Consumer Price Index for urban wage and clerical workers.

b. The Administration's projection is for the total labor force, including armed forces residing in the United States, while the CBO projection is for the civilian labor force excluding armed forces. In recent years, the unemployment rate for the former has tended to be 0.1 to 0.2 percentage points below the rate for the civilian labor force alone.

c. *Other personal income* is personal income less wage and salary disbursements.

d. Corporate profits reported are book, not economic, profits.

Table 3 COMPARISON OF ADMINISTRATION, CBO, AND *BLUE CHIP* SHORT-RUN ECONOMIC FORECASTS

	Estimated 1988	Forecast 1989	Forecast 1990
Fourth Quarter to Fourth Quarter (Percent change)			
Real GNP			
Administration	2.6	3.5	3.4
CBO	2.6	2.9	2.2
Blue Chip	2.8	2.3	1.9
Nominal GNP			
Administration	6.6	7.4	7.0
CBO	6.7	6.9	6.6
Blue Chip	6.9	6.7	6.3
Consumer Price Index[a]			
Administration	4.2	3.6	3.5
CBO	4.3	5.0	4.8
Blue Chip	4.4	4.8	4.7
Calendar-Year Averages (Percent)			
Three-Month Treasury Bill Rate			
Administration	6.7	6.3	5.5
CBO	6.7	7.9	7.1
Blue Chip	6.7	7.8	7.3
Ten-Year Government Note Rate			
Administration	8.9	8.3	7.2
CBO	8.9	9.3	9.0
Blue Chip[b]	8.9	9.0	8.4
Civilian Unemployment Rate			
Administration[c]	5.4	5.2	5.1
CBO	5.5	5.5	5.5
Blue Chip	5.5	5.4	5.7

SOURCE: Congressional Budget Office; Office of Management and Budget; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators* (January 10, 1989). The CBO forecast is based on preliminary 1988 fourth-quarter data published in January 1989.

a. Consumer Price Index for urban wage earners and clerical workers.

b. *Blue Chip* does not project a ten-year note rate. The values shown here are based on the *Blue Chip* projection of the AAA bond rate, adjusted by CBO to reflect the estimated spread between AAA bonds and ten-year government notes.

c. The Administration's projection is for the total labor force, including armed forces residing in the United States, while the CBO and *Blue Chip* projections are for the civilian labor force excluding armed forces. In recent years, the unemployment rate for the former has tended to be 0.1 to 0.2 percentage points below the rate for the civilian labor force alone.

Table 4. EFFECTS ON CBO BASELINE BUDGET PROJECTIONS OF SELECTED CHANGES IN ECONOMIC ASSUMPTIONS
(By fiscal year, in billions of dollars)

	1989	1990	1991	1992	1993	1994
Real Growth: Effect of One-Percentage-Point Lower Annual Rate Beginning January 1989						
Change in Revenues	-6	-20	-39	-59	-79	-102
Change in Outlays	1	4	8	14	22	32
Change in Deficit	7	24	48	73	101	134
Unemployment: Effect of One-Percentage-Point Higher Annual Rate Beginning January 1989						
Change in Revenues	-25	-41	-44	-46	-47	-50
Change in Outlays	4	8	13	18	23	28
Change in Deficit	29	49	57	64	70	77
Inflation: Effect of One-Percentage-Point Higher Annual Rate Beginning January 1989						
Change in Revenues	5	17	31	45	63	81
Change in Outlays	4	16	29	43	58	74
Change in Deficit	-2	-1	-2	-1	-5	-8
Interest Rates: Effect of One-Percentage-Point Higher Annual Rates Beginning January 1989, All Maturities						
Change in Revenues	--	--	--	--	--	--
Change in Outlays	3	11	16	20	24	29
Change in Deficit	3	11	16	20	24	29
Interest Rates: Effect of One-Percentage-Point Higher Annual Rates Beginning January 1989, Medium- and Long-Term Maturities Only						
Change in Revenues	--	--	--	--	--	--
Change in Outlays	1	5	9	13	16	20
Change in Deficit	1	5	9	13	16	20

SOURCE: Congressional Budget Office.

Table 5. - TRUST FUND SURPLUSES IN THE JANUARY CBO BASELINE
(fiscal year, in billions of dollars)

	1989	1990	1991	1992	1993	1994	Holdings, end of 1994
Social Security	56	68	79	90	103	117	618
Medicare	20	21	18	17	15	12	175
Military Retirement	14	15	16	17	17	18	138
Civilian Retirement	21	21	23	25	26	30	345
Unemployment	9	7	6	4	3	3	68
Highway and Airport	3	2	1	1	1	1	34
Other	-1	1	0	0	-1	-1	52
Total Surpluses	121	135	143	153	164	179	1,429
Federal Funds Deficit	-276	-276	-284	-288	-294	-301	
Total Deficit	-155	-141	-140	-135	-129	-122	

Table 6. COMPARISON OF CBO AND OMB ESTIMATES OF THE REAGAN ADMINISTRATION'S BUDGET PROGRAM
(fiscal year, in billions of dollars)

	1989	1990	1991	1992	1993	1994
Revenues						
CBO	893	1070	1143	1211	1283	1361
OMB	976	1059	1140	1212	1281	1345
Outlays						
CBO	1143	1190	1251	1306	1363	1426
OMB	1137	1152	1207	1244	1279	1312
Deficit or Surplus						
CBO	-160	-120	-108	-94	-80	-65
OMB	-161	-93	-67	-32	2	33
Deficit Targets	-136	-100	-64	-28	0	.....

Note: Totals include Social Security, which is off-budget.

Sources: Congressional Budget Office; Office of Management and Budget.

Table 7. - REAGAN ADMINISTRATION PROPOSED BUDGET CHANGES
(by fiscal year, in billions)

	1990	1991	1992	1993	1994
Defense spending	+2.1	+5.5	+7.5	+11.0	+14.9
Nondefense discretionary (net)	-4.3	-5.7	-7.2	-7.6	-9.5
Total progam increases	(3.5)	(6.0)	(9.7)	(9.9)	(11.1)
Total program reductions	(-7.8)	(-11.7)	(-16.9)	(-17.5)	(-20.6)
Entitlements	-18.0	-23.1	-26.9	-30.6	-35.1
Medicare	(-5.5)	(-8.7)	(-11.2)	(-14.2)	(-18.3)
Medicaid	(-1.7)	(-2.3)	(-2.8)	(-2.9)	(-3.1)
Other health	(-1.2)	(-1.4)	(-1.5)	(-1.6)	(-1.8)
Federal retiree COLA reductions	(-1.4)	(-2.3)	(-2.9)	(-3.4)	(-3.6)
Eliminate Federal retiree lump sum payments	(-2.1)	(-2.2)	(-2.4)	(-2.5)	(-2.7)
Farm price and income support	(-2.0)	(-1.9)	(-2.5)	(-2.5)	(-2.5)
School lunch	(-0.8)	(-1.0)	(-1.1)	(-1.2)	(-1.2)
End trade adjustment assistance	(-0.2)	(-0.3)	(-0.3)	(-0.3)	(-0.2)
Other	(-3.1)	(-3.0)	(-2.2)	(-2.0)	(-1.7)
Revenues (effect on deficit)	-13.1	-8.6	-6.3	-6.3	-5.4
Government receipts, including taxes	(-1.8)	(-3.8)	(-3.6)	(-3.3)	(-3.2)
User fees and offsetting collections	(-5.5)	(-2.9)	(-1.4)	(-2.9)	(-2.1)
Asset sales (net of lost receipts)	(-5.9)	(-1.9)	(-1.4)	(-0.1)	(-0.1)
Total Policy Changes (net)	-33.3	-31.9	-32.9	-33.5	-35.1
Debt Service Savings	-1.2	-2.9	-4.5	-5.8	-6.9
Total Deficit Reduction	-34.4	-34.8	-37.4	-39.3	-42.0

Source: OMB, House Budget Committee, and Committee staff.

Note: Sign indicates the effect on the deficit. Thus, revenue increases are shown as minuses. Also, detail may not add to totals due to rounding.
( ) indicates part of a subtotal.

Table 8. - REAGAN ADMINISTRATION PROPOSALS FOR PROGRAMS WITHIN THE JURISDICTION OF THE COMMITTEE ON WAYS AND MEANS
(OMB preliminary estimates, by fiscal years, savings in millions)

	1990	1991	1992	1993	1994	1990-94
OUTLAYS						
MEDICARE (Legislative)						
Part A:						
Current Law Extensions						
Hospital capital at 85%	-930	-1190	-1300	-1420	-1530	-6370
Legislation Proposals						
Reduce hospital capital to 75%	-620	-780	-880	-940	-1020	-4240
Reduce indirect medical education to 4.05%	-1020	-1290	-1410	-1540	-1660	-6920
PPS Update factor of MB - 1.5%	-625	-800	-875	-955	-1040	-4295
Graduate medical education reductions (HI)	-120	-130	-135	-140	-150	-675
Catastrophic Health Insurance Impact	-11	-22	-24	-25	-31	-113
Subtotal: Part A	-3326	-4212	-4624	-5020	-5431	-22613
Part B:						
Current Law Extensions						
Clinical Labs - keep 100% caps	-190	-330	-410	-480	-560	-1970
Legislation Proposals						
Freeze MEI for non-primary care physicians	-375	-960	-1640	-2085	-2400	-7460
Overpriced procedures	-100	-180	-210	-240	-270	-1000
Reduce radiology/anesthesiology/surgery payments by 8%	-250	-430	-510	-570	-640	-2400
New physician customary charges	-40	-110	-150	-190	-220	-710
Concurrent anesthesia	-15	-20	-30	-30	-30	-125
Designated specialities	-15	-25	-30	-35	-40	-145
Graduate medical education reductions (SMI)	-30	-30	-35	-40	-40	-175
Reduce outpatient hospital	0	-220	-520	-780	-940	-2460
Durable medical equipment - rental	-100	-150	-170	-190	-220	-830
Reduce oxygen reimbursement 5%	-30	-50	-60	-70	-80	-290
Enteral nutrients	-30	-40	-60	-70	-80	-280
Catastrophic Health Insurance Impact	-90	-160	-200	-250	-281	-981
Subtotal: Part B	-1265	-2705	-4025	-5030	-5801	-18826
Premiums						
Premium reductions due to savings	296	612	876	1076	1260	4120
Extend 25% SMI premium	-617	-1715	-2812	-4409	-6488	-16041
Total (Legislative):	-4912	-8020	-10585	-13383	-16460	-53360
Total (Regulatory):	-548	-698	-703	-883	-1115	-3947

Total, Medicare:	-5460	-8718	-11288	-14266	-17575	-57307
AFDC/CSE/QC/Foster Care						
AFDC/QC Proposals	-80	-80	136	115	92	183
CSE Incentive floor	-47	-48	-49	-51	-54	-249
CSE Services for food stamp children	-100	-100	-100	-100	-100	-500
Limit AFDC administrative cost	-123	-129	-124	-120	-124	-620
Cap Foster Care administrative cost	-65	-140	-219	-294	-366	-1084
Subtotal:	-415	-497	-356	-450	-552	-2270
TRADE ADJUSTMENT ASSISTANCE						
End Assistance	-196	-259	-262	-254	-244	-1215
TOTAL ALL OUTLAYS:	-6071	-9474	-11906	-14970	-18371	-60792
REVENUES						
Airport and airway trigger repeal	-892	-1553	-1678	-1805	-1946	-7874
HI coverage of state and local employees	-1831	-1915	-1916	-1906	-1910	-9478
Elimination of Superfund tax differentials	0	0	0	0	0	0
Customs user fee proposals (net budget effect)	197	86	24	133	159	599
Oil and gas depletion rules	39	49	45	47	45	225
R&E allocation rules	1699	749	814	887	967	5116
Extension of R&E credit	387	688	963	1150	1379	4567
Amtrak/Rail UI	5	2	-3	-4	-5	-5
IRS user fees	0	-48	-48	-48	-48	-48
TOTAL REVENUES:	-396	-1942	-1799	-1546	-1359	-6898
TOTAL DEFICIT REDUCTION:	-6467	-11416	-13705	-16516	-19730	-67690

Sources: HHS; Office of Management and Budget, Treasury.

Note: Sign indicates impact on deficit.

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Table 9. COMPARISON OF REAGAN DEFICIT REDUCTION PROPOSALS TO SEQUESTRATION USING OMB PROJECTIONS (in billions)

	1990	
	OMB Deficit Sequester	Numbers Reagan
National Defense	-13.0	2.1
Non-Defense Discretionary	-10.7	-4.3
Entitlements (total)	-2.5	-18.0
Medicare	(-1.5)	(-5.5)
Other	(-1.0)	(-12.5)
Revenues, Asset Sales, User Fees	0.0	-13.1
Net Interest	-1.0	-1.2
TOTAL DEFICIT REDUCTION	-27.2	-34.5

Source: Committee Staff.

Table 10. - OUTLAYS FOR MAJOR SPENDING CATEGORIES FOR SELECTED YEARS
IN NOMINAL DOLLARS, AND AS A PERCENT OF GNP
(by fiscal year)

	1965	1970	1975	1980	1985	1990	1994	Average Annual Growth Rate 1985-1994
				in nominal dollars (billions)				
National Defense	50.6	81.7	86.5	134.0	252.7	305	356	3.9
Social Security	17.1	29.4	63.1	117.1	186.5	247	318	6.1
Medicare	xxx	6.8	14.1	33.9	69.8	112	180	11.1
Medicaid	0.3	2.7	6.8	14.0	22.7	38	57	10.8
AFDC, SSI, Food Stamps	xxx	6.5	14.5	22.8	31.3	38	51	5.6
Other Entitlements	17.1	20.8	57.3	90.4	127.5	144	157	2.3
Non-defense Discretionary	32.5	45.1	85.3	156.6	175.8	206	233	3.2
Net Interest	8.6	14.4	23.2	52.5	129.4	182	203	5.1
Offsetting Receipts	-8.0	-11.6	-18.5	-30.3	-49.5	-64	-79	5.3
Total	118.2	195.6	332.3	509.9	946.2	1209	1480	5.1
Memo: GNP	672.6	990.2	1522.5	2670.6	3943.6	5542	7117	6.8
				as a percent of GNP				
National Defense	7.5	8.3	5.7	5.0	6.4	5.5	5.0	
Social Security	2.5	3.0	4.1	4.4	4.7	4.5	4.5	
Medicare	xxx	0.7	0.9	1.3	1.8	2.0	2.5	
Medicaid	0.0	0.3	0.4	0.5	0.6	0.7	0.8	
AFDC, SSI, Food Stamps	xxx	0.7	1.0	0.9	0.8	0.7	0.7	
Other Entitlements	2.5	2.1	3.8	3.4	3.2	2.6	2.2	
Non-defense Discretionary	4.8	4.6	5.6	5.9	4.5	3.7	3.3	
Net Interest	1.3	1.5	1.5	2.0	3.3	3.3	2.9	
Offsetting Receipts	-1.2	-1.2	-1.2	-1.1	-1.3	-1.2	-1.1	
Total	17.6	19.8	21.8	19.1	24.0	21.8	20.8	
Memo: Social Security, Medicare, and Medicaid	2.6	3.9	5.5	6.2	7.1	7.2	7.8	

Source: Congressional Budget Office

Chart 1. Major Spending Categories as a Percent of GNP

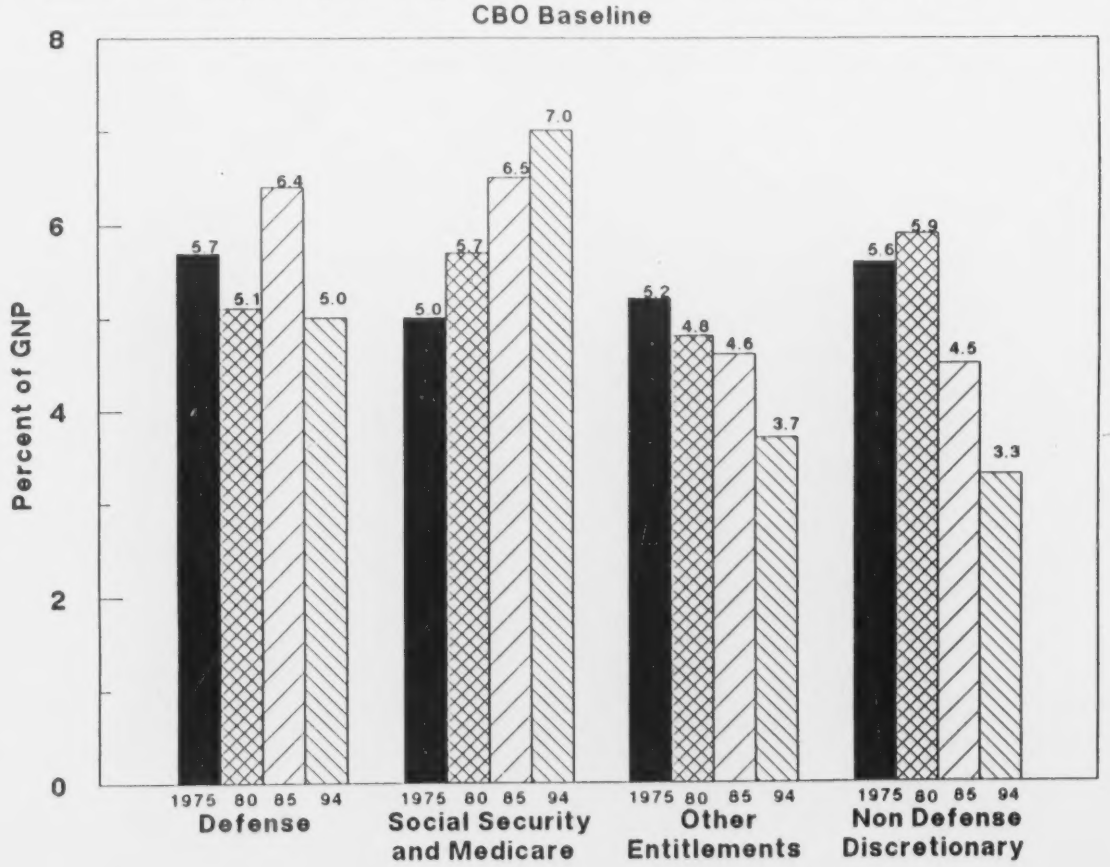

Table 11. - INCREASES IN SPENDING ONLY IF PRICE AND POPULATION ADJUSTMENTS SINCE 1980
(GNP Deflator)

	1980	1985	1990	1994	1994 CBO Baseline	Difference
National Defense	134.0	182.7	226.4	273.8	356	82.2
Social Security	117.1	159.6	197.9	239.3	318	78.7
Medicare	33.9	46.2	57.3	69.3	180	110.7
Medicaid	14.0	19.1	23.7	28.6	57	28.4
AFDC, SSI, Food Stamps	22.8	31.1	38.5	46.6	51	4.4
Other Entitlements	90.4	123.2	152.7	184.7	157	-27.7
Non-defense Discretionary	156.6	213.5	264.6	320.0	233	-87.0
Net Interest	52.5	71.6	88.7	107.3	203	95.7
Offsetting Receipts	-30.3	-41.3	-51.2	-61.9	-79	-17.1
Total	509.9	695.1	861.5	1042.0	1476	434.0

SINCE 1985
(GNP Deflator)

	1985	1990	1994	1994 CBO Baseline	Difference
National Defense	252.7	313.2	378.8	356	-22.8
Social Security	186.5	231.2	279.6	318	38.4
Medicare	69.8	86.5	104.6	180	75.4
Medicaid	22.7	28.1	34.0	57	23.0
AFDC, SSI, Food Stamps	31.3	38.8	46.9	51	4.1
Other Entitlements	127.5	158.0	191.1	157	-34.1
Non-defense Discretionary	175.8	217.9	263.5	233	-30.5
Net Interest	129.4	160.4	194.0	203	9.0
Offsetting Receipts	-49.5	-61.4	-74.2	-79	-4.8
Total	946.2	1172.7	1418.4	1476	57.6

Source: Committee staff based on 1994 CBO projections.

Table 12.- CBO BASELINE PROJECTIONS FOR PROGRAMS WITHIN THE JURISDICTION OF THE COMMITTEE ON WAYS AND MEANS FOR FISCAL YEARS 1988-94

(By fiscal year, in billions of dollars)

	1988 actual	1989	1990	1991	1992	1993	1994
Social Security(OASDI)...	218.0	231.6	248.0	265.5	282.8	300.6	319.1
OASI.....	196.4	208.7	223.5	239.2	254.8	270.7	287.2
DI.....	21.6	22.9	24.6	26.2	28.0	29.9	31.9
Medicare.....	87.6	98.5	114.0	130.1	146.8	164.7	183.7
HI.....	52.7	58.8	66.3	73.3	80.7	88.5	96.5
SMI.....	34.8	39.8	47.7	56.0	64.5	73.7	84.2
Catastrophic Drug insurance.....	0.0	0.0	0.0	0.8	1.6	2.4	3.1
Trade adjustment assistance.....	0.2	0.3	0.2	0.2	0.2	0.2	0.2
Unemployment assistance..	15.0	15.7	16.8	17.7	18.8	19.4	20.0
Family Support Administration.....	10.8	11.3	11.8	12.2	12.5	13.6	14.285
Earned income tax credit.....	2.7	3.8	3.9	4.1	4.4	4.6	4.8
SSI.....	12.3	12.5	12.4	14.3	15.4	16.4	18.8
Social services(Title XX)..	2.7	2.7	2.7	2.7	2.7	2.7	2.7
Child welfare, foster care, adoption assistance.....	1.3	1.6	1.4	1.4	1.5	1.7	1.8
SMI premiums.....	8.8	10.5	11.3	12.1	12.9	13.7	14.5
Catastrophic premium.....	0.0	1.2	1.8	2.7	3.6	4.1	4.6
TOTAL.....	359.3	389.7	424.3	463.0	501.5	541.6	584.6

Source: Congressional Budget Office.

Table 13. - CBO REVISED BASELINE PROJECTIONS FOR ENTITLEMENTS AND OTHER MANDATOR SPENDING CATEGORIES (By fiscal year, in billions of dollars)

Category	1988 Actuals	1989 Base	Projections 1990	1991	1992	1993	1994
			Means-Tested Programs				
Medicaid	30.5	34.2	38.2	42.5	47.0	51.7	57.0
Food stamps	12.3	12.8	13.9	14.8	15.3	16.2	17.0
Supplemental Security Income	12.3	12.5	12.4	14.3	15.4	16.4	18.8
Family Support Administration	10.8	11.4	12.1	12.8	13.1	14.1	15.0
Veterans' Pensions	3.9	3.9	3.8	4.0	3.9	3.9	3.8
Child Nutrition	4.3	4.6	4.9	5.3	5.6	6.0	6.3
Earned Income Tax Credit	2.7	3.8	3.9	4.1	4.4	4.6	4.8
Stafford Loans a/	2.8	3.4	3.7	3.6	3.6	3.6	3.5
Other	2.1	2.5	2.3	2.4	2.6	2.8	2.9
Total, Means-Tested Programs	81.7	89.0	95.4	103.8	110.8	119.3	129.2
			Non-Means-Tested Programs				
Social Security	217.1	230.6	246.9	264.3	281.7	299.4	317.9
Medicare	85.7	96.3	109.6	124.0	139.9	157.0	175.1
Subtotal	302.8	326.9	356.5	388.3	421.5	456.4	493.0
Other Retirement and Disability							
Federal civilian b/	30.3	32.6	36.3	39.0	42.2	45.6	49.2
Military	19.0	20.1	21.4	22.8	24.3	25.7	27.3
Other	4.8	5.1	5.1	5.3	5.5	5.6	5.8
Subtotal	54.2	57.9	62.8	67.1	71.9	76.9	82.2
Unemployment Compensation	13.6	14.2	15.1	15.9	16.9	17.4	17.9
Other Programs							
Veterans benefits c/	14.8	14.7	14.8	15.7	16.2	16.6	17.1
Farm Price Supports	12.5	13.3	11.3	11.5	9.4	7.4	5.9
Deposit insurance	10.2	17.1	11.8	13.0	8.2	7.8	6.8
Social Services	4.2	4.9	5.3	5.4	5.1	4.7	4.7
Other	7.2	10.2	12.3	12.4	12.9	13.0	13.2
Subtotal	48.9	60.3	55.6	57.9	51.9	49.6	47.9
Total, Non-Means Tested Programs	419.5	459.3	490.0	529.2	562.2	600.3	641.0
Total Outlays	501.2	548.3	585.3	633.0	673.1	719.6	770.2

a. Formerly known as Guaranteed Student Loans.
b. Includes Civil Service, Foreign Service, Coast Guard, and other retirement programs, and annuitants' health benefits.
c. Includes veterans compensation, readjustment benefits, life insurance, and housing programs.

Table 14. - HISTORICAL OUTLAYS FOR ENTITLEMENTS AND OTHER MANDATORY SPENDING
(By fiscal year, in billions of dollars)

CATEGORY	1975	1980	1982	1984	1986	1988
Means-tested programs:						
Medicaid	6.8	14.0	17.4	20.1	25.0	30.5
Food stamps a/	4.6	9.1	11.0	12.4	12.4	13.1
Supplemental security income	4.8	6.4	7.7	8.5	10.3	12.3
Family Support Administration	5.1	7.3	8.0	8.9	9.9	10.8
Veteran's pensions	2.7	3.6	3.9	3.9	3.9	3.9
Child nutrition	1.5	3.4	3.0	3.5	3.8	4.3
Stafford Loans b/	0.1	1.4	3.0	3.2	3.3	2.8
Earned Income Tax Credit	0.0	1.3	1.2	1.2	1.4	2.7
Other c/	0.1	0.1	0.3	0.5	0.9	1.3
Total, means-tested programs	25.7	46.6	55.5	62.2	70.9	81.7
Non-means-tested programs:						
Social Security	63.1	117.1	154.1	176.1	196.7	217.1
Medicare	14.1	33.9	49.2	61.0	74.2	85.7
Subtotal	77.2	151.0	203.3	237.1	270.9	302.8
Other retirement and disability						
Federal civilian d/	7.4	15.5	20.6	23.3	25.0	30.4
Military	6.2	11.9	14.9	16.5	17.6	19.0
Other e/	3.1	4.7	5.2	4.9	4.9	4.8
Subtotal	16.7	32.1	40.7	44.7	47.5	54.2
Unemployment compensation	12.8	16.9	22.2	16.8	16.1	13.6
Other programs:						
Veteran's benefits f/	10.2	11.0	12.5	12.8	12.9	14.8
Farm price supports	0.7	2.8	11.8	7.8	26.2	12.8
General revenue sharing	6.1	6.8	4.6	4.6	5.1	0.0
Social services	2.9	3.7	3.4	4.4	4.0	4.2
Other g/	3.4	7.3	3.5	4.4	1.8	17.1
Subtotal	23.3	31.6	35.8	34	50	48.9
Total, non-means-tested programs	130.0	231.6	302.0	332.6	384.5	419.5
Total outlays	155.8	278.2	357.5	394.8	455.4	501.2

a/ includes nutrition assistance for Puerto Rico.
b/ Formerly known as Guaranteed Student Loans.
c/ includes social services and special milk program.
d/ includes Civil Service, Foreign Service, Coast Guard, and other retirement programs, and annuitants' health benefits.
e/ includes general retirement and disability insurance (excluding social security.
f/ includes veterans compensation, readjustment benefits, life insurance, and housing programs.
g/ includes a wide variety of programs. The growth between 1975 and 1980 is due in part to increases in energy programs, international financial programs, and health care services. The growth between 1984 and 1985 is mainly due to an increase in housing assistance.

Table 15. - CBO BASELINE REVENUE PROJECTIONS BY SOURCE
(By fiscal year)

Major Source	1988 Actual	1989 Base	Projections 1990	1991	1992	1993	1994
			In Billions of Dollars				
Individual Income	401	433	481	520	558	596	636
Corporate Income	94	103	112	120	125	129	136
Social Insurance	334	365	391	417	441	468	497
Excise	36	34	34	32	31	32	32
Estate and Gift	8	8	8	8	8	8	8
Customs Duties	16	16	17	19	20	21	22
Miscellaneous	20	23	25	25	26	26	27
Total	909	983	1,069	1,140	1,209	1,280	1,359
			As a Percentage of GNP				
Individual Income	8.4	8.4	8.8	8.9	9.0	9.0	9.1
Corporate Income	2.0	2.0	2.1	2.1	2.0	2.0	1.9
Social Insurance	7.0	7.1	7.2	7.2	7.1	7.1	7.1
Excise	0.7	0.7	0.6	0.6	0.5	0.5	0.5
Estate and Gift	0.2	0.2	0.1	0.1	0.1	0.1	0.1
Customs Duties	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Miscellaneous	0.4	0.5	0.5	0.4	0.4	0.4	0.4
Total	19.0	19.2	19.6	19.6	19.5	19.5	19.4

SOURCE: Congressional Budget Office.

Table 16. - FEDERAL REVENUES BY SOURCE, IN NOMINAL DOLLARS AND AS A PERCENTAGE OF GNP FOR FISCAL YEARS 1965, 1970, 1975, 1980, 1985, 1988, 1990, AND 1994

Revenue source by type of tax	1965	1970	1975	1980	1985	1988	1990	1994
In nominal dollars (billions):								
Individual Income	48.8	90.4	122.4	244.1	334.5	401	481	636
Corporate Income	25.5	32.8	40.6	64.6	61.3	94	112	136
Social Insurance	22.2	44.4	84.5	157.8	265.2	334	391	497
Excise	14.6	15.7	16.6	24.3	36.0	36	34	32
Estate and Gift	2.7	3.6	4.6	6.4	6.4	8	8	8
Other	3.0	5.8	10.4	19.9	30.6	36	42	49
Total	116.8	192.8	279.1	517.1	734.1	909	1069	1359
As a percentage of GNP:								
Individual Income	7.2	9.1	8.0	9.1	8.5	8.4	8.8	9.1
Corporate Income	3.8	3.3	2.7	2.4	1.6	2.0	2.1	1.9
Social Insurance	3.3	4.5	5.5	5.9	6.7	7.1	7.2	7.1
Excise	2.2	1.6	1.1	0.9	0.9	0.7	0.6	0.5
Estate and Gift	0.4	0.4	0.3	0.2	0.2	0.2	0.1	0.1
Other	0.4	0.5	0.6	0.8	0.8	0.7	0.8	0.7
Total	17.3	19.5	18.3	19.4	18.6	19.0	19.6	19.4

Note: Columns may not add due to rounding.

Source: Congressional Budget Office, "The Economic and Budget Outlook: Fiscal Years 1990-94."

Table 17. - NET SAVINGS AND INVESTMENT FLOWS AS A PERCENTAGE OF GNP
[NIPA basis]

	(1) Net private domestic savings	(2) State and local surplus	(3) Federal deficit	(4) Net domestic savings available for domestic investment (1)+(2)-(3)	(5) Net private domestic investment	(6) Net domestic savings shortfalls (5)-(4)= net capital inflows
1950-59	7.5	0.2	-0.1	7.8	7.5	-0.3
1960-69	8.1	0.0	0.3	7.8	7.1	-0.7
1970-79	8.1	0.8	1.7	7.2	6.9	-0.3
1980	6.4	1.0	2.2	5.2	4.9	-0.3
1981	6.6	1.1	2.1	5.6	5.5	-0.1
1982	5.5	1.1	4.6	2.0	2.0	0.0
1983	5.7	1.4	5.2	1.9	3.1	1.2
1984	6.8	1.7	4.5	4.0	6.6	2.6
1985	5.7	1.6	4.9	2.4	5.1	2.7
1986	5.3	1.3	4.8	1.8	5.1	3.3
1987	4.3	1.0	3.4	1.9	5.3	3.4
1988	4.5	1.2	2.8	2.9	5.3	2.4

Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

Report
to the
Forty-First President of the United States

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Part I

A Personal Message To the 41st President of the United States: From Gerald R. Ford and Jimmy Carter

America has made its choice of a new President, and we personally commend you on your victory. With the people of this nation we unite in pledging our support to you as you prepare to accept the enduring responsibility of all Presidents: to preserve the national security of the United States, to bring about a more prosperous people and nation, and to advance the cause of freedom and justice, here and throughout the world.

Every Presidential election seems to be a watershed, a marking point in history by which men and women date public events and memorable occurrences in their own lives.

Yet the world does not stop and start as the guard changes; in our time in the Presidency we learned, as all Presidents do, that America's problems and opportunities respect no election calendar.

Continuity is essential for a strong Republic. For that reason the two of us agreed a year ago to become chairmen of American Agenda, a bipartisan group of private citizens who have a continuing and constructive interest in good, sound government. All had served with us, with other Presidents, and in other ways in public life; all wanted to help the next President. We and our co-workers set for ourselves this task: Look at the state of the nation and the world, draft an agenda of the major problems the next President will inevitably face, and suggest options for resolving them.

Each President has his own priorities and his own world view. It is manifest from your record of public service and from the Presidential campaign just ended that you have yours. Our effort here is neither to subvert nor supplant the agenda on which you were elected.

Rather, we—as veterans of the Oval Office, who know the exhilaration and challenges of the Presidency, who have exercised Presidential power and know its reach and its limits, who have been where you will be and who have made the same kinds of decisions you must make—wish to help you get off to a fast and successful start in dealing with the daunting problems and the challenging new world you inherit.

Yours is an extraordinary legacy. What good fortune you have to lead this greatest of nations in these times!

Your political powers are at their peak now, in the glow of your victory. With all of our fellow Americans we want you to make the most of your mandate and the bipartisan good will which embraces any new President.

The single most important message we can convey to you is a personal one:

You, like only forty other Presidents who have been privileged to serve in the office, will hold in your hands the greatest of obligations and the greatest of opportunities.

Being a candidate for President and being President are two very different things, as you are soon to discover fully.

You have won the right to test your solutions to the most serious problems facing

our country. But as your long career in public service has taught you already, what is preferable and what is possible are frequently at odds.

Franklin D. Roosevelt, offered some sound advice when he said, "Try one method and if it fails, try another." There is no disgrace in adjusting your course to meet changing realities; but there may be danger in failing to do so.

Facing reality—dealing with the world as it is while working to reshape it as you would like it to be—is the ultimate responsibility of every President. It's what Harry Truman meant when he said, "The buck stops here."

Beginnings

The two of us decided to begin this report to you not with major policy issues, which we will address in Part II, but by drawing on our own memories and experiences on the job. Each of us had his own lucky breaks, and each of us made his own share of mistakes. At least we know where some of the land mines are, so these observations from our own practical experience could be of value as you prepare to assume the Presidency.

Transition

First, our experience was that actions we took and statements we made during the transition period were crucial. Looking back, each of us recognizes that our first steps established the perception and shaped the reality of much that came later.

Actually there are two transitions: One is from government to government; the other is your personal transition from candidate to President-elect. The first takes ten weeks, the second is up to you.

We respectfully suggest that as soon as you can, turn away from the campaign mode and look ahead. Winning a Presidential election is as heady as it is historic, and you and your campaign managers and workers have every right to be proud of your success in winning. Now it is time, we believe, to store away your campaign hats and ways, to change from leader of your party to leader of the nation.

You have a new responsibility now. The people who ran your campaign will not in all cases be the best people to run your Administration. Although you certainly have political obligations, your closest friends and strongest supporters will best serve you by understanding that all things are different now that you will sit at the desk in the Oval Office.

The transition is a time of both great promise and great peril. While it is essential to make some substantive choices during the transition, hasty actions prior to your inauguration can be dangerous. We recommend that you make only those policy decisions that are necessary to get your Presidency off to a fast start and hold off on the rest until your Administration is organized and has full access to all the information and resources you will have as President.

Cabinet and Staff: Getting the Best

Nothing is more important to your success as President and to the national interest than your choices of the men and women who will help you manage the White House and the Executive departments.

Your transition team, if they are like most, will fall into a struggle between the substantive people and political people.

We remember well the demands on a President's time, but we found that time invested in fitting candidate to job was time well spent. Some people are natural advocates; they belong in a department or agency which you have targeted for change. Others are managers; they may be better in a department where you wish to maintain current programs. Still others are temperamentally better as honest brokers; they may serve best on your staff. But all should view themselves as part of the team which has collective and continuing responsibility for advising you on policy and for supporting and carrying out your decisions.

Similarly, all of your transition leaders will need to know what you as President hope to accomplish, what your priorities are, and what kind of people you want to appoint to carry out your goals. With your clear objectives in hand, your senior transition staff can better identify and recruit candidates for your Cabinet, deputy and assistant secretaries, and White House staff. If, for example, you want to increase dramatically the Federal role in education, they can bring in names of men and women with the experience and temperament to accomplish your goals in education.

At most, we found, you can interview personally only about 50 of the 1400 persons you will appoint to important offices. Since this cadre will be your surrogates in creating and managing a unified Administration, we would encourage you to spend some time with them so that they understand what you expect of them and feel part of your team from the outset.Too often Presidential appointees lack a clear understanding of what is expected of them.

One good goal for your transition personnel staff is to find and recommend to you people who can work together in a set of collegial relationships. For instance, it is important that your Secretaries of State and Defense, your National Security Adviser and your CIA Director not only be qualified for their jobs but able to work together as your National Security team.

Your candidates for the Cabinet will need to know to what extent they will be allowed to choose their subordinates. We feel that Cabinet members should have a strong say in who works for them, but we both kept the right to select or approve deputies and assistant secretaries who were our field commanders in carrying out our policies.

As important as your Cabinet are the senior members of your White House staff. Each of us decided at first not to have a White House Chief of Staff. Experience proved us wrong. The Executive Office of the President is in itself a bureaucracy that must be made to work as a cohesive unit.

Both of us found that a White House Chief of Staff is essential to make sure that the Executive Office and the senior and subordinate staff are well organized to meet the daily crises, to coordinating policy development, and to work in concert with the Cabinet and the Congress to see that your policies and decisions are carried out.

A good Chief of Staff must have the full confidence of his President. Inside the White House he should be able to manage policy issues as well as strong-minded people; he should be skilled in advancing your programs and objectives. Outside the White House, he should be recognized as politically experienced, knowledgeable in the ways of Washington and Capitol Hill. He must have a talent for dealing with the press; he should be principled, indefatigable, and without immediate political ambitions. He should also have the courage to disagree with you.

Next to the Chief of Staff, we turned most often to the National Security Adviser. He is your first source of information about most events that affect the vital interests of the United States.

In our judgment the National Security Adviser should be a person who is knowledgeable in national security affairs, loyal to you, and objective. He should be a highly competent manager of information, issues and experts. It is best if he is by nature self-effacing, a person who prefers to stay out of the public eye, who will not create public conflict with your Secretary of State and Secretary of Defense.

His first responsibility, we believe, is to coordinate the work of the National Security Council and staff, to keep you informed, to advise you what State, Defense and other departments propose to do, and to make his own recommendation to you.

Each of us found it essential that the National Security Adviser have direct and immediate access at any time, day or night. You may want him to be responsible to the Chief of Staff, as President Ford did, and as The Tower Commission recommended. Both the Chief of Staff and National Security Adviser should come in to the Oval Office together for briefings and discussions on national security issues; or, as you direct, it should be the National Security Adviser's responsibility to inform the Chief of Staff promptly about the discussion, any decision made and any action taken.

From the first days after your inaugural you can expect some measure of conflict among members of your Cabinet and between Cabinet and White House staff. It is inevitable, for you want strong people with strong views, and they will differ. We well remember that it is not easy to mediate among close advisers, to tell one that you accepted the view of the other; but it is necessary.

It is appropriate, we believe, for you to make it clear early and often that you want your Cabinet and staff to voice vigorously their opinions to you before your decision. But once you have made your decision, they must understand that you expect them to support it—or resign.

Executive-Legislative Relations

Nothing is more important to your success as President than your relationship with Congress, and nothing will consume more of your time as President than your work with Congress.

Congress can make or break a President. This was true when we were in office; from what we observe today, Congress exercises even more power now than it did then.

It is commonly supposed that the Constitution made the President and Congress equals and gave each separate powers; the reality is that the two exercise shared and overlapping powers.

Without Congressional support your major initiatives will go nowhere. The election returns may encourage the public and the members of your new Administration to assume that you have a popular mandate to change almost at will old policies and pass your own new programs.

To some extent that may be true. You can certainly lead, and it will be easiest during your first months in office. But you will need Congress at every step and every turn.

To govern effectively, you must share power. If your support with the public

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erodes you may find it almost impossible to persuade Congress to follow your lead.

Creative tension between the Executive and Legislative branches is established by the Constitution. But it seems to us that in recent years, unfortunately, the comity between the two branches, essential to the orderly functioning of the Federal system, has broken down. Distrust has supplanted accommodation, and the American people are the losers.

We think it is an absolute requirement that there be a better rapport between the next White House and the next Congress, and we believe you are the only person who will be able to bring that about.

From our perspective, the best course for you is to set the broad agenda, as Congress will expect you to lead. But at the same time it is necessary that you listen to Congress, that you cooperate with Congress, cultivate the leaders and members of both Houses and both parties, and to the extent that you can, negotiate principal areas of responsibility for each of the two branches. Once a structure of cooperation is established, you will have your best chance to persuade Congress to move your programs.

This means that your Cabinet and key members of their departments will need to spend an enormous amount of time not only in formal hearings and meetings with House and Senate leaders, committees and sub-committees, but also in private discussions. The key members of your Administration should be selected with an eye toward their ability to work effectively on your behalf with Congress. It also means that much of your own time will be spent talking to members on the telephone, in private meetings, on Air Force One, at breakfasts and briefings in the White House.

We recommend that you begin to establish good relations with Congress before your inaugural. For example, as soon as the House and Senate elect their new leaders, we believe that you should invite them to meet with you, your choices for State, Defense, Treasury and NSC, and their relevant committee leaders for a long December weekend in the country. At such a first session you would not need position papers or a formal agenda; creating a personal rapport is more important. We should suggest a similar meeting with your top economic advisors and congressional leaders to discuss a bipartisan solution to our nation's budget deficits.

The time and effort in such sessions before your inaugural could be an excellent investment and would send a reassuring signal to the nation.

Moreover, the two of us believe, on the basis of discussions with members of both parties in the House of Representatives and Senate, that a number of Members are ready for greater accommodation if you as President are willing to consult with Congress before major policy decisions are made.

From our discussions, there appear to be two areas where effective compromises are possible, and we recommend that you undertake discussions toward these objectives:

First, on foreign policy, it is evident to us that there is a unique opportunity to forge a bipartisan agreement in most areas. We believe that Congress would be willing to reduce sharply its efforts to invade your areas of responsibility and to try to micromanage U.S. foreign policy if you, on a regular basis, bring in the Leaders of the House and Senate and the responsible committee leaders during the early stages of foreign policy decision making.

Second, on the budget: We believe that if during the transition and the early

weeks after your inaugural, you open negotiations with the Leaders of Congress and the responsible committee leaders, you can reach an agreement for at least a two-year plan that will provide the basis for the budgets for fiscal years 1990 and 1991 with significant deficit reductions. In return, you could seek greater authority to rescind spending decisions by Congress.

Strike a balance in how many Presidential proposals you have before Congress at any time—something we learned from experience. If you send up too many bills, Congress will be confused about your real priorities. Yet too few leaves a vacuum, and members may try to move in with their solutions. Congress likes to be busy, but not overloaded. They need to know your priorities, and there is only room for a few at a time.

Make friends of the leaders in both Houses and both parties. Take them into your confidence whenever you can. Like most of us, they do not like to be surprised. Much of their power as leaders rests on their knowing what is going on and what is about to happen. As a general rule, early consultation, even given the risks of premature leaks, pays greater dividends than surprise initiatives.

The national interest depends, we believe, on improving relations between the President and the Congress, on mutual respect and the restoration of cooperation. This is a challenge for every President; we believe you can bring back the mutual respect and consideration that should characterize the relationship between every President and every Congress.

White House Organization and Procedure

Presidential decisions are never easy, and all are important. There is no process or organization that can substitute for your own best judgment. But these judgments must be well informed, and the secret to being informed is teamwork and an organized process that produces the best advice.

Each President organizes his Administration in ways that fit his style, and properly so.

Every major international and domestic problem ends up on the White House doorstep. Few are simple. None comes in a neat package labeled foreign policy or transportation or trade; almost every major issue involves two or more departments with different interests. Consequently, you need your White House organization and procedures set up to make sure you have the best information, the most expert counsel, and a system to resolve the inevitable differences between departments and advisers.

1. We strongly recommend that you preserve the primary function of the National Security Council as defined in the National Security Act of 1947, that is, to make recommendations to the President on policies concerned with the national security. Neither your National Security Adviser nor the NSC staff should be operational arms of the government. They are to coordinate policy, present new ideas and proposals, not implement them. There are exceptions—occasions when the National Security Adviser has been assigned the responsibility to carry out a President's policy. But there is a clear distinction between the National Security Advisor undertaking a specific mission, as Henry Kissinger and Zbigniew Brzezinski did for us in China, and the staff of NSC involved in field operations. The Advisor should not undertake any special assignment except at your direction and under your supervision.

2. We believe that international finance and trade are increasingly important economic issues which must be coordinated with domestic, economic and foreign policy issues. Thus we would include the Secretary of the Treasury in the NSC.

3. President Ford would create an Economic Policy Council, as he did, with the Secretary of the Treasury as Chairman, and the Secretary of State and the NSC Advisor among the members, to provide a channel of information and counsel on all domestic and international economic affairs and to coordinate all economic policy issues.

4. President Carter would also create an Economic Policy Council with the same members, but would coordinate international economic policy through the National Security Council.

5. We recommend that you depoliticize the Office of Management and Budget. OMB's figures and data are now viewed with suspicion. You and the government will be best served if you insist on strict neutrality, professional competence, and institutional memory from OMB. Your annual budgets are the keys to decisions by Congress; they must be accepted as professional and objective.

6. We recommend that you elevate the President's Science Advisor to Assistant to the President for Science and Technology, in recognition of the increasing number of Presidential issues related to science and technology, from national security to energy and the environment.

[The Decision Making Panel in Part III, and appendices in Part IV present more detailed comments and proposals on White House organization and procedure.]

Command in Crisis

We believe it is essential that incoming Presidents be given a through and careful briefing on the nuclear command system. No knowledge is more important to you than how the chain of information and command would function in a crisis, and what options are available to you in response to each kind of nuclear or non-nuclear threat, or to a report of imminent or actual attack. We are concerned also that in an emergency some degree of control could be assumed by someone other than a President or his Constitutional successor.

We understand the reluctance of Presidential advisers and Presidents to invest blocks of time in discussing hypothetical doom, or engaging in practice exercises related to the possibility of nuclear war. Both of us understand that crisis plans are of ultimate confidentiality, and that questions of Presidential survival and succession are intensely personal.

Nevertheless, we respectfully recommend that every newly elected President, Vice President-elect, and certain Presidential designees, such as the Secretary of Defense, White House Chief of Staff and National Security Advisor, be given a comprehensive briefing on all aspects of the nuclear command and control system. We also recommend that every new President, upon taking office, take appropriate steps to instruct all subordinate military commands on his preferred location and his own plan for command, communication and control in a major emergency, and that each new President's plan include a clear and Constitutional order of Presidential succession.

An Open Door

The White House has access to information without limit, from all over the world—

more than any other institution. Yet the White House can be isolating, and keep you from hearing the information you really need to have.

We both learned that White House staff members have a tendency to barricade the premises, to protect the President from all the visitors they don't want him to see.

Their intentions are good; they know that your hours are limited and the demands heavy. To keep a perspective on all things, we found it useful to meet as informally as we could with a wide range of private sector leaders.

We learned from our efforts to keep in touch with the American people, found the time well spent, and commend it to you as one way to keep in touch with the great world outside the White House gates.

In addition, it may be useful to meet regularly with elder statesmen who have your confidence and who can share with you their diverse perspectives. Finally, every President needs an old friend who has no axe to grind with the government, who has good judgment about public affairs, who is loyal, a good listener, totally discreet, and not on your payroll.

Now and then he or she can sit down with you on the Truman balcony, join you in a quiet moment, listen, and when others do not, tell you the truth.

The Bully Pulpit

Once you are inaugurated you will find, as we did, that your greatest opportunities for moving your policies and actions rest not on the explicit powers delegated by the Constitution. Instead, the real power of the Presidency is your authority to communicate, to teach, to inform, to lead—the power that President Theodore Roosevelt called the "bully pulpit". You have unparalleled access to the public, both directly and through the news media. There will be many occasions when you will want to take your message directly to the American people. But it will be most effective if it is used sparingly, so as not to diminish the impact of truly Presidential issues.

In addition, we would suggest that you meet frequently with representatives of the news media, both formally in news conferences and also in informal settings where your primary purpose will be to share with reporters and in turn the public the context in which your decisions and policies are being made.

In these and other ways you can focus attention on a problem, a need, a crisis, and by Presidential assertion alone help to solve it. You can touch the hearts and hopes of Americans and of other people around the world.

You can assert the values you believe America should honor, and you will find that more and more people will respond to and respect and follow those values.

We share the confidence placed in you by millions of your fellow Americans, and we shall watch with the greatest personal and professional interest how you establish your authority as President and lead the nation toward your own goals for America.

Each of us would also like you to know that we stand ready to help in any way.

Good luck from the two of us. God Bless You.

S/ Gerald R. Ford S/ Jimmy Carter

Part II

Observations and Priorities
By Gerald R. Ford and Jimmy Carter

A year ago, when American Agenda began, the two of us asked ourselves how we might through this initiative best help the next President, and through him, our country.

We decided that it could be beneficial to a President-elect, immediately after the rigors and partisan intensity of the campaign, to have a short list of the most difficult problems he is likely to face after he is elected, and realistic options for solving these priority problems.

To work with the two of us we invited eight Republicans and eight Democrats, all distinguished in public life, to be leaders of this volunteer enterprise, and they in turn enlisted the wisdom and experience of over 320 additional experts and advisers.

To organize our effort we asked bipartisan teams to undertake five areas of study—Economic Policy, Domestic Policy, Foreign Policy, Defense and Arms Control, and Presidential Decision-Making. As a guideline we proposed that each team identify and define the priority issues in their area, and offer suggestions for resolving them.

We are most grateful to each of them. Their depth and breadth of knowledge enabled the group to survey a wide range of issues affecting the present and future of the United States.

In the process the two of us learned a great deal. As we met and took part in the discussions of major issues—ranging from arms control to the Federal deficit to the quality of high school education to the Arab-Israeli conflict—and as we saw the quality of the work being done by the members of the Executive Committee and the advisers they recruited, we found ourselves deeply engaged in looking at the future of America and the world from the perspective of our terms of service in the White House.

On the basis of these reflections, our own experience, and the assessments of the American Agenda members and advisers, the two of us offer three summary observations about the state of the nation and the world, submit our best judgment about an order of priorities among the many compelling problems you are most likely to face, and suggest a range of options for addressing these problems.

Observations

We are struck, first of all, by the way the country is changing and the way the world is changing. It is essential, we believe, for Americans to recognize these changes and what they mean to their lives and to the nation.

Americans feel good about themselves, and rightly so, for there is an abundance of prosperity at home and an absence of major war abroad. But now that the campaign is behind us, the two of us believe it is time to face reality. It is our view that great problems have been postponed, and great decisions must now be made.

The structure of world power is changing. The long American Era after World War II during which the United States was the dominant economic, military and political force in the world is slowly evolving into a more uncertain and challenging time.

The bi-polar world of the post-World War II era, with two dominant superpowers and largely subservient allies, is gone. A new world is emerging with multiple centers of power.

Of course the U.S. and the U.S.S.R. remain as the world's military superpowers. But their capacity to control events has diminished. The tragic American experience in Lebanon and the Soviet defeat after its brutal invasion of Afghanistan underscore the limits of superpower military actions in the Third World.

The U.S. and our Allies, at least for the moment, have stopped the political and military advances of the Soviet Union, partly because of American strength and resolve, partly because the Soviet Union's planned socialist economies failed the Russian government and people, and partly because of a new and different Soviet leader.

The U.S.S.R. is on the defensive within its own empire. Nationalism is reasserting itself inside the borders of the Soviet Union, while the Poles, the Czechs, and the people of other Soviet bloc countries are pressing for greater independence. Soviet troops have begun to leave Afghanistan, but slowly; Cuba seems prepared to reduce or even eliminate its forces in Angola. There is some evidence that the Soviets may be playing a constructive role in Cambodia.

Communism is in political disarray; the old simple and straightforward threat posed by a unified and openly expansionist Communist world under Soviet command has abated for now.

Yet we are deeply concerned that Soviet troops remain in Afghanistan, that the Soviet military program does not reflect Gorbachev's moderate rhetoric, and that the Soviet leaders have yet to demonstrate a sincere desire to promote peace in critical areas such as Central America and the Middle East. Our judgment is that yours will be a safer world from the perspective of possible superpower confrontations. But the risk of conventional wars will continue as long as dangerously volatile political and territorial conflicts continue in the Middle East, in Central America, in Asia, in Africa.

This changing world, less under the control of the U.S. or the U.S.S.R., is being shaken by a dramatic explosion in technology—in telecommunications, transportation, agriculture, biomedicine, all of which offer great hope for bringing the world closer together and improving the lot of mankind.

But there is a dark side to advancing technology, demonstrated by the spread of ballistic missiles and arsenals of chemical and biological weapons in the Middle East and Persian Gulf.

Still, as we see it, tomorrow's struggles for most of the peoples of the world will be for better standards of living, for ways to escape poverty, hunger and deprivation, for commerce and trade, for the jobs that a nation's economic growth creates; and this brings us to our second observation about a reality the United States must face:

The new force in the world is neither arms nor political ideology; it is economic power, operating in an increasingly interdependent world economy.

The United States, which used to be the preeminent economic power in the world, has lost its hegemony.

By the most reliable yardstick of raw economic power, Gross National Product,

the United States still ranked first in GNP last year, at $4.5 trillion. Second, and advancing rapidly, are the nations of the European Economic Community, which expect to become a united economic marketplace in 1992, with $3.6 trillion. The Soviet Union, with a GNP estimated to be in the range of $1.5 to $2.4 trillion, could be third—or fourth, behind Japan, which reached $2.1 trillion in 1987 and is still gaining. Just last year Japan claimed first place in the world in per capita GNP, advancing to $19,642 and relegating the U.S. to second place with $18,403.

Four other Asian countries—South Korea, Taiwan, Hong Kong and Singapore—have average GNP growths of 6 percent to 8 percent yearly; their share of world trade has tripled since 1960.

All this international competition, this shifting economic power, makes a difference: In 1950 the U.S. produced 33 percent of the Gross National Product of the world; today it produces only 26 percent, and the U.S. share continues to decline.

This slowdown in relative U.S. growth is not just a dry statistic: As nations express power, it represents a shift in economic weight in the world. As a pocketbook issue, it makes a difference in how much American workers get paid. From 1963 to 1973, the real income of working Americans increased steadily at an average annual rate of 2.6 percent. Since that time, real wages have stagnated. From 1960 to 1980 the American economy expanded at an average annual growth rate of 3.3 percent, but since then the growth rate has been only 2.6 percent yearly. Japan, one of our strongest competitors, also had a slowdown in its growth rate after 1980; but from that year through 1987 Japan was still growing by 3.7 percent yearly, substantially ahead of the United States.

America is still Number One economically, but—

Gone is the simpler world of the dominant dollar and its predictable exchange rate.

Gone is the American role as the biggest lender of capital to the world; now the U.S. is by far the world's biggest borrower of capital.

Gone is the overwhelming American lead in productivity. U.S. productivity overall remains at a high level, but in the last fifteen years growth in U.S. productivity has slowed. Japan's is gaining.

Gone is the historic American trade surplus. The U.S. imports about $150 billion more products and services than it exports. Foreign barriers to American exports are certainly part of the problem; but so too is the lack of competitiveness of U.S. products and the high and continuing American demand for foreign cars and foreign oil.

And gone is the international trading system responsive to U.S. control. After World War II the United States set world standards for quality and technological leadership; and American corporations dominated or equalled the best foreign rivals. Since then, international competitors have successfully closed many of the technological gaps that once existed and have begun to capture—or have captured—domestic and international markets that were once dominated by U.S. firms.

Fifteen years ago, American companies made 95 percent of the telephones and 80 percent of the television sets in American homes. Today American companies make one in four telephones and one in ten TV sets sold in the U.S.

The U.S. share of world automotive output declined from 52 percent in 1960 to 23 percent in the 1980's, and now one out of every four cars driven in America is foreign made. Similarly, the U.S. share of world steel production declined in the same period

from 26 percent to 11 percent.

It is not that America is in economic decline. The U.S. economy continues to grow at a modest rate, and to benefit from low inflation and low interest rates.

What is different now is that other nations such as Japan, West Germany, France and Canada are catching up to us, and in some markets bidding to take the lead.

Such success among our Allies should not dismay America's workers or businessmen, or America's political leaders, for this new economic world the U.S. confronts now is a world the U.S. created.

After World War II, as an act of generosity and with the high purpose of creating a new order of economic prosperity that would motivate nations to keep the peace, President Truman and Congress granted through the Marshall Plan $100 billion in 1950's dollars to restore Western Europe.

In Japan, General Douglas MacArthur reformed land ownership and thereby founded a prosperous and stable farm economy. MacArthur broke up Japan's family-owned trusts and redirected their initiative and energies into consumer products. American businessmen and universities welcomed the enterprising Japanese to the U.S., taught them management, sold them U.S. technology, converted them to U.S. democratic capitalism.

Far from wishing to rule the world or perpetuate our postwar position of dominance, we set out to rebuild and strengthen our economic competitors, and, by sending financial aid to the Third World, to bring new players into the system. It was a policy without precedent. Never in history has a world power been so generous. Yet none of President Truman's successors doubted the correctness of his decision.

America designed, engineered and financed this new economic world. The question now is: How do we compete in a world we taught to compete with us?

The answer: Just as the world has changed, so must this nation change, not by retreating into a protectionist and defensive posture against the new reality of worldwide competition, but to show all nations that American skill and technology and enterprise can lead in the future as in the past.

This brings us to our third observation, which is about the home front, the U.S. itself.

We see two Americas, one increasingly wealthy, one tragically poor, a land of opportunity for most and of idle hopelessness for too many, a nation never so prosperous or so profligate. And in between are middle Americans, many of whom are struggling to hold their own.

We find an America that is swiftly changing—changing in values, ideas, in the way we live, work, profit, build, learn, raise children, aspire, communicate, pursue the good life, teach the young, care for the old.

The country has experienced an extraordinary period of prosperity—70 straight months of economic improvement; 123,732,000 Americans are employed, the most ever. The proportion of the working age population holding jobs stands at a record 62 percent.

Never has this country offered greater opportunities. American business has created more good, skilled-labor jobs than there are men and women qualified to fill them.

And yet, at the same time, never have so many Americans been trapped in pov-

erty, in slums, in homelessness, in illiteracy, in crime, in an underclass.

It is not our purpose to draw either a bleak or a rosy picture of the U.S., but to let the facts and the challenges that flow from these facts speak for themselves. Here, from the U.S. Census Bureau, the Bureau of Labor Statistics and other official sources, are demographic snapshots of America:

- Wealth and poverty in the United States continue to go up. The wealthiest 20 percent of Americans received 44 percent of aggregate income in 1987, up from 40 percent twenty years earlier. The poorest 20 percent of Americans received 4.6 percent, down from 5.5 percent in 1967.
- Immigration into the U.S. is changing the American profile. In the 1990's one third of our population growth will come from immigration, mostly from Mexico, the Caribbean and Asia. By the Year 2000, one new worker in three will be a member of a minority.
- The technology revolution is reshaping the workplace. More than 70 percent of Americans now work in the service sector of data processing, telecommunication, banking, travel, health care, selling, consulting and education. More than one worker in four uses a computer on the job, and that number is increasing steadily.
- Job opportunities are expanding. American business, small and large, has an urgent need for more engineers, computer operators, electronics technicians, physicists, chemists—jobs that require a good basic education. But American high school students know less science and math today than they did in 1975, and each year 500,000 teenagers drop out of high school to find a menial low-paid job or drift into idleness.
- The American family is changing. A child in America today spends less and less time with his parents. One out of five lives with one parent, and that parent usually works. For the children who live with two parents, 55 percent of the time both mother and father work.
- Americans used to be home-buyers; now more and more are renters because they cannot afford a home. In 1975 67 percent of young married couples had enough income to meet the mortgage payments on their first home; by 1985 only 40 percent could afford that first home.
- Americans stopped saving for the future; they tend to spend all they make, and more. Fifteen years ago Americans saved 9.2 percent of after-tax income; last year it was 3.2 percent.
- Borrowing has become a way of life. The government of America, the businesses of America, the families of America—all are deeper in debt than ever before. In 1987 American corporations owed 56 percent of their net worth, and American consumers owed 85 percent of their after-tax annual income.
- America is getting older. Senior citizens—all those Americans over 65—are increasing as a percentage of the population more than twice as fast as the rest of the people. Today the U.S. has 30 million elderly; in 40 years there will be 65 million. America will be the first country ever where one in five citizens is more than 65 years old.
- America is healthier. Adult Americans are exercising more, smoking less and drinking less, but one out of ten between the ages of 20 and 40 uses illegal drugs

at least once a week.

- American medical skills and facilities are the best in the world. But one out of six Americans has no health insurance to pay the doctor or hospital.
- Americans are spending more and more time on the road. They drive 119,849,000 cars to the job, to the shopping center, on weekends and on vacation, and burn 307 million gallons of fuel a day. It takes the average U.S. worker 43 minutes to get to work and back; 12 percent spend 90 minutes a day commuting by car. Only 6 in 100 Americans use public transportation to get to work.
- Violence is increasing. After a five-year decline in crime rates through 1986, robberies, rapes, assaults, burglaries and car thefts went up almost 2 percent last year. In the American West, the most dangerous part of the country, a citizen stands one chance in eight of being attacked, robbed or raped, and one chance in four that someone will break into his home or steal his car.

These statistical highlights, plus our own observations, add up to a complex picture of America—mostly comfortable, well off, not worried, feeling good about itself and the future, enjoying life; but another part of the nation is poor, forgotten, out of work and out of hope.

From your travels and experiences of the campaign you have your own strong impressions of America, complementing your own convictions about where you intend to lead the nation, about your own agenda for America. Your election as President is eloquent proof that you share the values and aspirations and expectations of a majority of the American people.

The two of us feel strongly about the importance of every President setting his own goals and objectives. We are confident that you will as well. We do not presume to try to substitute our agenda for yours. Moreover, our list is by no means intended to include all that you as President will be called upon to consider. We both found that unanticipated events force their own priorities on a President's agenda, as they will on yours. But we would like to share with you our perspective on what we believe will be the priority problems you will face as President, the options that are available to meet them, and the areas of bipartisan agreement on solutions.

We see these challenges as creating positive opportunities for Presidential leadership to guide the United States to an even brighter tomorrow. None of the problems we identify, difficult though they are, is beyond the capacity of this country to solve with the Presidential leadership we are confident you will provide.

We have divided our priorities into two categories:

First are those issues that we believe require immediate decisions and actions:

1. The Budget Deficit

2. National Security and Arms Control

3. The FSLIC Crisis

4. Third World Debt and International Trade

5. Children at Risk

6. U.S. Relations with Allies

Second are ongoing Presidential priorities—issues of compelling and intrinsic importance but not as demanding in urgency or requiring immediate action:

1. Productivity, Competitiveness, Education & Job Training

2. U.S. Relations with the U.S.S.R.

3. Mexico and the United States

4. Nicaragua and Central America

5. The Environment

6. Drugs

First Priorities

The preeminent responsibility for every President is national security; it continues from the first moments in office to the last hour. There is never a day when a national security issue does not come to your desk.

However, the Federal budget deficit currently dominates all other decisions—allocations for national defense, domestic needs, and capital investments.

Arms control may be considered the first priority globally and in national security terms; the deficit is of first importance domestically and economically. The two issues are of equal importance, but we believe the one that will require your most urgent attention is the Federal budget deficit.

1. The Budget Deficit

The Federal debt, now $2.8 trillion and mounting at the rate of about $12 billion every month, is not an abstraction; in real dollars it works out to a debt of about $37,000 for every family in America. It is a symbol of our unwillingness to match our resources to our demands and our own ends, to try to make critical choices among competing priorities.

The current forecast is for continuing deficits and ever higher public debt. Even under optimistic assumptions of no recession for the next four years and no real growth in defense spending, the Congressional Budget Office estimates that the Federal deficit—although it will decline from $155 billion this year—will still be $120 billion in 1993, the year when the Gramm-Rudman-Hollings Act requires a budget balance.

Nobody has a credible plan to reduce the annual deficit below $120 billion yearly, much less pay off the Federal debt. Not since 1969 has any Congress or any President been able to balance the annual budget. Instead, the Federal government spent and borrowed and postponed the reckoning. At the end of 1970 the Federal debt was $382 billion; ten years later it was $914 billion; in the last eight years it has soared to $2.8 trillion.

The result: Every American worker pays an average of $4 a day in taxes just to pay interest on his share of the Federal government debt. The Federal government is now spending one out of every seven dollars in the budget just for interest on the debt and thereby limiting the nation's ability to meet basic and generally accepted responsibilities—from the defense of the country to investments in education, job training, housing and health care, to the mundane but essential need for more traffic controllers, bank examiners, drug enforcement officers and environmental protection agents.

No longer do we owe this money to ourselves, or pay interest to ourselves. About one-third of the interest Americans pay leaves the country, sent as a sort of a financial tribute to wealthy strangers in Japan, Germany and the Middle East. We must borrow

from abroad, because all the savings of Americans are not enough to support the Treasury's weekly need for more money. As a consequence, some of the biggest decisions about the financial future of the U.S. are now in the hands of foreign investors.

The Federal deficit dominates decision-making in Congress, in the White House, throughout the Federal government. To every new initiative or urgent need the response is: "How do we pay for it?" In the most recent example, Congress passed a comprehensive and badly needed $2.4 billion law to combat the drug problem, and authorized $1 billion for the first year to increase prevention, treatment, and enforcement. But the Gramm-Rudman-Hollings budget ceilings forced Congress to halve the initial appropriation, to $500 million.

The Federal deficit has a profound effect on American business and enterprise. The Treasury's continuous borrowing inflates interest rates; every home buyer pays more for his mortgage because of Federal debt and deficits. The U.S. borrows so heavily that most of the savings of the American people are being taken by Washington, so there is less and less capital to be invested in the small and medium-size American businesses that produce the jobs and growth and economic vigor that improves standards of living for all.

But Washington is not alone at fault. The fact is that the American people demand more in Federal government services than they are willing to pay for. As citizens, Americans have come to accept a vast public debt as no real problem.

We believe that it is time to face reality, to remind all Americans that no one—neither a person nor a family nor a business nor a nation—can continue indefinitely to spend more than he has.

The two of us have been responsible for Federal budgets and struggled with cuts in spending and taxes, and done our best to cope with Federal deficits, so we know how difficult the choices are. We cannot say, nor can the best economists foresee, what consequences will follow if annual Federal deficits of more than $120 billion continue. But we are concerned about the inflation that great public debt ultimately brings; we are concerned that foreign investors may lose confidence in America's economy, which could lead to a dramatic increase in interest rates, recession and even higher deficits. We are concerned that standards of living in the U.S. will not increase and can decline if the Federal government continues perennial deficits that push the national debt higher and higher.

We believe it is time to begin to put the U.S. fiscal house in order.

We recommend that you:

- **lead the nation to make a national commitment to the principle that the United States government must live within its means.**
- **begin working during the transition period with the Congressional leadership to develop a bipartisan budget agreement covering at least two and preferably four years to balance the unified Federal budget by the mid-1990's.**
- **include in this agreement the goal of an annual reduction in the deficit of $40 billion so long as there is no recession.**

Our Economic Panel recommended three basic options for balancing the Federal budget—a freeze on spending, moderate cuts in spending and moderate taxes, and a larger tax increase. (Part III).

We both would accept a freeze in Defense at current levels adjusted for inflation,

and recommend these spending cuts and non-income tax increases: We would continue cost-of-living increases for Social Security recipients and Federal pensioners at CPI −2%; cut Medicare fees for doctors, agriculture price supports, spending for public works and transportation; and impose moderate increases in user fees and taxes on motor fuel, beer, wine and cigarettes—with a goal of reducing the annual deficit by $40 billion yearly until the Federal budget is balanced in the mid-90s.

President Carter believes that the non-income tax increases we support should make up the difference between the reductions specified and our $40 billion deficit goal.

Both of us, however, believe that one of these options, variants of them, or still another proposal to balance the Federal budget is preferable to continuing deficit spending into the indefinite future.

No one of these options, or any other combination of spending cuts and increases in revenue, will be politically attractive. But from our experience in talking with Americans this year we believe that the majority of people understand that something must be done to reduce the Federal deficit; and we believe that a realistic plan would command national support if advocated by both the new President and the new Congress.

The first and essential step toward balancing the Federal budget is for the political leaders in Washington to face reality: deficits are hurting the country.

We believe it is time for Democrats and Republicans to talk economic sense to the American people, to tell them that ever-continuing deficits are unacceptable, that American citizens must pay for the Federal government services they elect their Representatives and Senators to provide.

[The Economic Policy Panel analyzes these and other economic issues in its report in Part III.]

2. National Security and Arms Control

In a most direct way, the ultimate responsibility of every President is the protection of the United States against external threat. To the two of us, as to every President, the capability of the country to defend its own interests and those of its Allies and friends around the globe take precedence, always.

We believe the challenges in national security, particularly with the constraints of budget limits, are extraordinary; but so is the opportunity to reduce the risk of nuclear war and a European conflict by completing a START agreement and a conventional arms agreement.

At the outset, we believe, there is an important step to be taken to maintain continuity in America's long-standing commitment to reduce the threat of nuclear war.

We respectfully recommend that you declare that the START talks and conventional arms talks will proceed with no break in continuity.

With the signing of INF Treaty an important step has been taken by the U.S. and the U.S.S.R. to establish an arms control environment. But some of the most far-reaching decisions relating to the START talks have not yet been resolved.

To go forward with that commitment there are in our view four major, closely connected issues that will require your immediate and subsequent decisions:

The first relates to strategic weapons and nuclear arms control; the second to conventional forces, particularly with respect to NATO, and conventional arms con-

trol; the third to the defense budget; and the fourth to defense management.

For arms control, two related strategic force decisions must be made:

1. Whether to have an ICBM that is survivable against a surprise attack from existing Soviet submarine and ICBM forces? That first decision, which has been debated for two decades, will establish the foundation for the U.S. substantive positions in the START talks, and affect all other defense decisions—strategic, conventional, and budgetary.

2. What is the U.S. approach to conventional arms reductions in Europe; and what is the U.S. position on burden-sharing? To what extent, that is, will the new Administration ask the West European Allies to share a greater part of the cost of defense against the threat from Eastern Europe?

Since your decisions on these and other defense questions are as vital to Western Europe as to the U.S., leaders of the Allies will be waiting to hear your views and intentions, and we believe it is important that you place a high priority on consulting with Allied leaders on these and other issues.

As you and your national security team consider these questions, we urge you to emphasize the extent to which your strategic decisions for START and on other issues set the framework for the national security decisions of Presidents who succeed you.

A President arms not primarily his own strategic forces but the future strategic forces that will protect the United States. For example, the nation's present deterrence against nuclear attack rests, first, on a decision by President Franklin Roosevelt to build the atomic bomb, and second, on a decision by President Truman—against contentious political and scientific opposition—to build the thermonuclear bomb that remains the Free World's basic weapon of deterrence against nuclear attack. National strategy is currently based on a Triad of weapons—bombers first ordered by President Eisenhower, ICBMs that were first deployed under President Kennedy, and Trident submarines that were initiated by President Johnson and ordered by President Nixon.

We continue to believe the Triad remains the most important deterrent to nuclear attack. We therefore believe that serious strategic, political and arms control problems would result if the United States, as part of a START Treaty, does not modernize U.S. ICBMs with a system that can survive a surprise Soviet attack.

We recommend that the U.S. continue its vigorous research on a missile defense system.

We are aware of the questions about its cost and effectiveness. We understand that a 100 percent effective missile defense system is unrealistic, and that commitment to an otherwise survivable ICBM that would reduce the need to protect our own strategic offensive forces. Yet there is solid information that the Soviet military forces are working to develop a strategic defense system, and we believe it is essential that a vigorous but affordable U.S. research effort be continued.

In response to the second strategic decision on conventional forces, this will require close coordination with our Western Allies. The issue of burden-sharing will be particularly difficult. We believe that the primary objective of conventional arms control in Europe is to undercut the Soviet ability to launch a quick, successful conventional attack based on their superiority in armor and artillery. In this respect we believe that you should encourage NATO to move toward national specialization in providing for the common defense.

Defense Budget. The Pentagon is now in the process of cutting over $200 billion from existing defense plans for the next five years. Given the size and persistence of the Federal deficit, even deeper reductions may be necessary.

We could not accept less than a minimum necessary for a sound defense, but we see little chance for more. This will present critical choices among forces and systems, and we encourage you to invest your own time and energy and that of the best of your advisers in making these choices.

We would not presume to suggest choices, but on the basis of our experience we recommend you consider:

- **moving units from active to reserve status—a far better option than wholesale reductions in the size of forces or reducing readiness.**
- **relying more heavily on smaller ships and submarines, and keeping carrier battle groups closer to the U.S.**
- **making greater use of unmanned aircraft—cruise missiles and drones—to undertake some missions for which more costly manned aircraft are now required.**
- **using more simulators and electronics for training.**
- **trying to convince Congress to accept multi-year funding for major weapons systems, and a two-year defense budget cycle to promote stability and savings, and major base closings.**
- **directing your Secretary of Defense to make the policy changes suggested by the Packard Commission—changes that could save $15 to $20 billion annually.**

Defense Management. The most important decisions relating to Pentagon management are your appointments as Secretary of Defense, Deputy Secretary of Defense, and the other senior Defense officials who will be responsible for managing Pentagon affairs. You will depend on them, the other civilians who are involved in procurement and management, and on their knowledge and abilities and background

A series of reforms proposed by, among others, the National Academy for Public Administration, would be helpful in getting talented and knowledgeable appointees who understand defense procurement into the right jobs.

We believe that able people can make the Pentagon work fine, but without able people, the Pentagon will not be well managed.

Defense Concept. It has been more than a decade since a President updated and publicly stated the mission of U.S. defense forces.

We believe it is timely now that this be done, not only because military and strategic developments make it wise, but tight Federal budget allocations make it imperative.

All too often, the Pentagon and Congressional committees tend to commit to weapons, systems, bases and forces that have no clear relationship to a defense mission.

We recommend that you:

- **define national defense objectives,**
- **base U.S. defense commitments on these objectives; and**
- **direct the Department of Defense that U.S. commitments will determine our investment and spending on armed forces, weapons and all other elements of defense.**

The Packard Commission recommended that the National Security Council develop and direct for the President a statement of national security objectives, priorities among those objectives, major policies to carry out those objectives, and defense spending to support those objectives. We concur.

We believe the U.S. will have a stronger defense—and importantly, greater public acceptance of defense spending—if U.S. forces are more closely related to an American defense mission that is sustained by popular understanding and support.

[The Defense and Arms Control Panel and our Foreign Policy Panel analyze these and other national security and foreign policy issues and summarize options in more detail in Part III.]

3. The FSLIC Crisis

The Federal Savings & Loan Insurance Corporation, the U.S. government institution that insures the savings institutions in the U.S., is technically insolvent.

Moreover, an estimated 500 individual savings and loan associations are also insolvent by generally accepted accounting principles, and another 400 are in such difficulty that they are likely to fail.

This does not mean that the millions Americans who have $1 trillion on deposit in the 3,000 savings institutions around the country are at risk. Their deposits are fully protected by the full faith and credit of the United States government.

What it does mean is that the FSLIC, the insurance division of the Federal Home Loan Bank Board that regulates the thrift industry, is short by an estimated $50 to $100 billion of the amount it needs to pay off the depositors of the S&Ls that are insolvent but still operating and still losing money.

In fact, one reason that the doors of these S&Ls remain open is that FSLIC cannot afford to pay off the depositors. So these insolvent banks continue to (a) offer high interest to depositors, (b) make risky loans, some of which go unpaid and put them deeper into debt, and (c) put FSLIC deeper in debt.

In effect, an insolvent privately-owned thrift is permitted to obligate the Federal government to guarantee its losses.

The problem is getting worse, as losses to FSLIC are increasing by an estimated $1 billion every month, according to the General Accounting Office. The longer the delay in acting to solve the problem, the worse it will become, and the more it will cost to handle.

The savings and loan industry, and FSLIC, got into their financial difficulties for three reasons: collapse of the high real estate and energy markets, particularly in the Southwest; inadequate capital and accounting standards; and insufficient oversight by the Federal Home Loan Bank Board. The Board—with the approval of Congress—decided not to close, sell or merge the troubled thrifts but to encourage them to try to grow their way out of their problems, leading them to make even riskier loans.

Thus far, the public's faith in the Federal government's deposit insurance system has prevented a collapse in the thrift industry; and it is generally assumed that this faith will continue. However, since one in six savings and loan associations is insolvent, and since the FSLIC insurance fund is in such weak financial condition, it must be considered that a sudden development or unexpected crisis—such as a stock market crash or an increase in interest or inflation rates—could trigger a wholesale flight of depositors from the thrifts. If this should occur, the effect on the U.S. economy and on the world economy could be devastating.

In summary, we find this to be the situation:

- The FSLIC crisis is a severe problem now, and getting worse week by week.

- The current approach of merging or selling insolvent institutions by issuing FSLIC notes defers but does not solve the problem.
- There are some assets in FSLIC and the savings & loan industry for paying off depositors, and the maximum funds to pay the depositors must be raised from the industry through the continuation of the special premium assessment, use of FSLIC's existing resources, and incentives for commercial banks and holding companies to take over failing thrifts.
- For the balance—the difference between what FSLIC, the industry, and the private sector can raise and what is needed to resolve the FSLIC-S&L crisis—the next President and Congress must go to the taxpayers, but this imposition should be kept to the minimum.
- If this burden is imposed on the taxpayers, the Federal government will owe it to them to do business differently in the future.

We recommend that you and your senior fiscal and economic advisers consult with Congress as soon as possible, and jointly with Congress create a plan to:

- **raise $50 to $100 billion to pay off the depositors in the insolvent savings and loans banks and thereby resolve the immediate crisis through a combination of private and public resources, and**
- **reform the Federal deposit insurance system in a way that protects depositors' insurance funds from such losses in the future, and examine the future of the thrift industry.**

Among the alternatives for providing the funds to FSLIC:

1. Enact a one-time special tax for this purpose only.

2. Authorize FSLIC to borrow from the Treasury enough money to pay off the depositors.

3. Authorize the Home Loan Bank Board, through the FICO mechanism, to issue up to $50 billion in long-term bonds backed by the full faith and credit of the U.S.

4. Amend tax laws to encourage investment firms to buy non-performing real estate loans held by FSLIC.

To preserve the integrity of the Federal deposit insurance system, we recommend the following for your consideration:

1. Close, within two years, all insolvent S&Ls that cannot meet capital requirements.

2. Raise accounting and capital standards for all thrifts, and improve supervision.

3. Bring about an administrative merger between FSLIC and the Federal Deposit Insurance Corporation under a regulatory board empowered to enforce uniform standards of accounting and capital standards for all commercial and savings and loans banks.

[The Economic Policy Panel analyzes the thrift problem and offers more detailed discussion and recommendations in Part III and in an appendix in Part IV.]

4. Third World Debt and International Trade

Trade and the related issue of third-world debt can no longer be relegated to technicians. Both are, in our opinion, Presidential level issues and should be treated as such throughout your Presidency. They will require your personal attention, resources, and deserve high priority on your agenda.

Despite some improvement, our trade deficit remains high, unacceptably high, a

symbol of our lack of international competitiveness and a reflection of our budget deficit.

Trade is no longer an arcane economic issue; it has profound foreign policy impacts. Trade frictions with our allies can weaken our alliances. New challenges lie ahead, such as the creation of a Single Market in 1992 for the European Community, the world's largest trading block, which must not be turned into a protectionist market against U.S. products.

So, too, Third World debt is not simply an issue for commercial banks holding huge unpaid and unpayable loans. Debt cripples growth in Latin America and in the developing world, with a consequent drop in their purchases of American goods.

The U.S. trade deficit will remain high so long as demand is depressed in the Third World by their huge debt obligation. Third World debt, like trade, has far-reaching political ramifications; it is weakening moderate democratic forces in Mexico, Brazil, Argentina and other countries, and strengthening opposition leaders with radical approaches to the debt issue and overall relations with the United States.

Trade. The imperatives of the calendar require early decisions and actions. The Uruguay Round of Trade Negotiations is entering an important stage with a December mid-term review and will present major challenges to the U.S.; a series of major sectoral decisions must be taken, beginning in 1989 with steel; several rescheduling negotiations, notably Argentina, will come to a head in early 1989; and there is a Seven Nation Economic Summit in June 1989.

We recommend that you:

- **during the transition choose a U.S. Trade Representative of significant political stature who is respected on Capitol Hill and credible to the U.S. private sector, provide him or her direct access to you, and include your USTR in all major trade discussions with foreign leaders.**
- **work with President Reagan's representatives to issue a strong statement in support of the bipartisan goals of the U.S. in the Uruguay Round, during the mid-term December review in Montreal.**
- **direct your USTR to place a priority on developing a code of services, meaningful intellectual property protection, clear rules for U.S. foreign investment abroad, a reduction in agricultural subsidies, and strengthened GATT dispute resolution procedures.**
- **articulate an American trade policy that places primary emphasis on multilateral negotiations. But where multilateral progress cannot be made, negotiations should proceed among small groups of like-minded nations within the Uruguay Round or toward bilateral agreements modeled after the U.S.-Canada and U.S.-Israel Free Trade Agreements.**
- **take a few early actions under the new 1988 Trade Act to establish the credibility of American fair trade policy by using the threat of retaliation in particularly blatant cases of truly unfair trade practices.**
- **work with the European Community to assure that the creation of their Single Market does not create further barriers to trade.**
- **appoint a more permanent group of "wise men" or develop a high level forum at the ministerial level with Japan which will lead to a comprehensive approach to anticipate and head off troublesome issues, and to avoid frequent confrontations**

with Japan over trade at a time when we need their financial resources to help with Third World economic development and debt relief.

Third World Debt. We also believe rapid action will be needed to develop a strategy on Third World debt. Despite six years of U.S. economic growth and lower domestic interest rates, real interest rates are the highest ever; and third-world debt has not eased and, for most nations, has worsened—measured by the ratio of debt to GNP. The Baker Plan helped avoid a crisis but we believe that events have passed it by and a new direction is needed, using it as a point of departure. The longer the problem continues, the greater the chance one of the big Latin American debtors will suffer a social, political, or economic crisis.

We recommend you direct your new Treasury Secretary, in consultation with your Secretary of State, private banks and with the major multilateral institutions, to develop an approach to the third-world debt problem by the time of the June Economic Summit.

A Japanese plan has already been developed and it is important that the U.S. retain the lead.

The new Omnibus Trade Act calls for the Treasury Secretary, the Federal Reserve and others to respond with a plan in 1989, with the first deadline in February for an interim report to Congress. In anticipation of that, we believe you should direct the Secretary of the Treasury to accelerate U.S. leadership in concert with the G-7 governments and the world banking and trade institutions (including GATT) to develop additional ideas and approaches for dealing with the very serious problems of Third World debt, with the goals of reversing outflows of financial resources from the very countries that most need capital for their development, and accelerating the overall growth of world trade.

There are several possible solutions in addition to the more active use of traditional techniques, including: an international agency to buy third-world debt from the banks at a discount; an IMF trust to hold industrial nation bonds deposited by debtor nations to collateralize a new issue of their own bonds which would be swapped at a discount for their existing bank debt; debtor nations could exchange newly issued bonds for bank loans; a fund to cap interest payments could be created; debtor nations could be allowed to make debt payments in local currencies which banks could not repatriate for several years, the World Bank could make guarantees of a portion of interest payments on new loans or bonds.

Whichever solution is chosen, we recommend it should be based on the following principles:

- **It should lead to a reduction of the net outflow of capital from Third World countries. In 1980 there was a $35 billion annual net transfer of funds from rich to poor nations. Now there is a $30 billion annual net transfer from poor to rich nations.**
- **Costs and benefits must be shared among debtor nations, banks, and industrial countries, with nations like Japan fully enlisted to provide their resources.**
- **Case-by-case arrangements should be tailored to the circumstances of particular debtor nations.**
- **The U.S. should support active roles for the World Bank, IMF, and regional development banks.**

- **Any new financial instruments created in exchange for debt should be liquid and negotiable.**
- **Debtor nations should be encouraged, by incentives and penalties, to undertake growth and efficiency-oriented reforms. At the same time debt relief and new loans should be used to encourage Third World countries to protect and not destroy their rain forests and other environmental resources.**
- **Distinctions should be made between the poorest nations, advanced nations with inadequate domestic policies, and advanced countries with currently sound fiscal programs.**

Acting promptly on trade and third-world debt can avoid manageable problems becoming unmanageable ones later in your term.

5. Children at Risk

In the U.S. today, one child in five is poor. This is intolerable in history's richest nation. Children make up the biggest single segment of the 32 million Americans who live below the official poverty line.

The number of poor adults and senior citizens declined in recent years as unemployment went down and as Social Security benefits went up; but the number of poor children increased. Now the nation has 13 million children in poverty and at risk, and the number continues to increase.

Their problem is both human and economic.

First, children born into poverty today, particularly in our troubled inner-city neighborhoods, face a much greater prospect of life without hope—marked by a higher probability of crime and drug abuse, of dropping out of school, of becoming a teenage parent, of being in a continuing cycle of welfare dependency.

Second, children in poverty have a national economic impact as well, now and over the long term. The U.S. will need *all* of its children educated and trained for the tight labor market and increasingly complex skills of the 1990's and beyond. Each year's high school dropout class costs the country $340 billion in lost productivity and foregone taxes.

All the evidence available suggests that helping a poor child is a good public investment. The Committee on Economic Development estimates that $1 spent in early intervention saves $5 in the cost of remedial education, welfare, and crime control.

There is no easy answer to the problem of ingrained poverty. But early intervention in the lives of poor children offers the best opportunity to break the cycle of poverty. There is solid evidence that Federal programs such as Head Start, prenatal care, immunization, the Women's Infant and Children feeding program and compensatory education do work, and offer one of the best investments the country can make in its own people. To cover all eligible children with these programs would cost from $9 to $13 billion yearly. Because of the lack of funds, only about 20 percent of eligible children can participate now in Head Start.

Spending public funds for these young Americans is not wasteful; it is wasteful *not* to invest in the medical attention, the education and the job training that will provide poor children with a share in the American opportunity.

We understand the budget constraints on any expansion of Federal spending programs; but we believe that it would be imprudent to delay any longer on taking Federal action to begin the long process of assisting these children of poverty.

We recommend that you:

- **set a goal of full Federal funding for Head Start, WIC, Compensatory Education, prenatal care, immunization and preventive health care programs for all eligible disadvantaged children within eight years, and**
- **move toward that goal by recommending in your Fiscal 1990 budget an annual increases of $2 billion until the goal is reached.**

We also urge you to publicly encourage successful state, local and voluntary initiatives, and to provide funding for selected model demonstration projects focused on good parenting and child support.

To pay for these investments in our children we suggest reductions in less essential domestic programs, such as Amtrak subsidies and the Economic Development Administration, savings which we believe will occur in farm subsidies from the market-oriented agricultural policy our Domestic Policy Panel recommends, and, if necessary, part of the revenues from higher cigarette and alcohol taxes.

6. U.S. Relations with Allies

From the day of your election through the first months of your Administration, three key issues will be important in U.S. relations with Allies:

- Your assurances about the continuity of commitments.
- Your dealings with President Gorbachev and the U.S.S.R.
- Your actions on domestic and international economic issues.

With every new President, our principal Allies in Europe and the Pacific rim look for reassurance about the new Administration, and especially about U.S. security commitments. This change occurs in a very different world than at the time of the last change of an Administration eight years ago.

The U.S. economy is increasingly rivaled by other nations. Our economic preeminence has slipped. Constrained budgets will make it challenging for America to sustain its relative weight in NATO. Western Europe is moving toward greater independence with its Single Market in 1992. Japan and the Pacific Rim countries are increasingly powerful economically. The Soviet Union, weaker politically and economically, is demonstrating greater flexibility and can be expected to seek to drive a wedge between the U.S. and Western Europe through beguiling offers to denuclearize Europe.

All of this will make it critical that early attention be given to Allied relations as a first foreign-policy priority.

The Allies are most interested in continuity; it is important, therefore, that you convey early on that you support the panoply of existing U.S. commitments.

The visit of Prime Minister Thatcher to Washington in November may offer a good opportunity and appropriate occasion for you to express your views on U.S. policy and attitudes on the security of Europe, and the degree to which policies undertaken by past Presidents will continue. These include the nuclear guarantee, support for the doctrine of flexible response, and maintenance of U.S. troops in Europe. All these points flow naturally from your public positions during the campaign and earlier, but the Allies will need to have reassurance from you as the President-elect.

From the point of view of the European Allies, next in importance is laying out your views on relations with the Soviet Union—views that will have been worked out in close consultation with NATO so that a united front can be presented to Gorbachev.

Here, too, the Allies are interested in continuity and consistency. The Administration and its predecessors have established a pattern of East-West relations that is worth continuing: greater stability and predictability, forward progress on arms control.

Mr. Gorbachev has made major inroads in Western Europe in terms of his image as a man of peace. He has met with the major leaders and has made a number of far reaching proposals on arms control and intra-European relations. The Allies will look to you to reassert U.S. leadership in East-West diplomacy;, and to do so in close coordination with them. It is important that the West be proactive, not reactive.

The staging of arms control negotiations will be important. The Allies are particularly interested in progress at the START talks, and will look to you for early indications of how you intend to proceed, and for assurances that they will be consulted throughout the course of the negotiations.

There is some disagreement within the Alliance at the moment about the modernizing of short-range nuclear forces in Europe. The Reagan Administration proposed moving forward with modernizing the Lance missile, but the West Germans are resisting it—across the political spectrum. Gorbachev is also playing on West German concerns about nuclear weapons, and is trying to get negotiations started on removing all short-range nuclear forces. Britain and France agree with the U.S. position that the Soviet proposal would weaken the U.S. nuclear tie to Europe. You will want to give thought about how best to counter Gorbachev. Perhaps the best way to do so would be to press on with START and also to give early backing to the projected new East-West negotiations on conventional force reductions, the Conventional Stability Talks (CST).

From the point of view of the Europeans and the Japanese the key test of your leadership will be in economics. Indeed, the touchstone of the Allies' judgment will be your plans for dealing with the U.S.budget and trade deficits. This is as much symbol as substance, since if the U.S. could end its trade deficit abruptly, Allied economies would suffer from loss of export markets.

The Allies do not expect you to have all the budget, trade and other economic answers—at least not at first. But they will look for early indications of your concern to begin reducing the U.S. budget deficit and to reassert a major U.S. role in leading the global economy.

The critical importance of economics leads us to propose a sequence of actions directly affecting relations with Allies:

We recommend first, that you inform the Allies of the basic plan you have worked out with Congress to gain control of the budget, and second, that you begin working with the Allies on global economic issues to reduce the economic and trade tensions which impair Western policy unity.

These problems are not all on the U.S. side, of course, but also include access to foreign markets, the European Community's Common Agricultural Policy, the impact on our trade position of the Community's 1992 "single market" moves, and the necessity of assuring that Europe's internally free market does not turn a protectionist face to the U.S., and especially the Third World debt problem that continues to worsen.

All these items will naturally be part of the agenda at the 7-Nation Economic Summit in France in July. But we believe it is important for you, as you talk with the Allies on security issues, to take the initiative on these issues long before then.

We also suggest that you ask the Allies to join in a basic reassessment of the

European security situation, especially in light of what Gorbachev is doing. It would be useful to look again at the East-West conventional military balance—which still heavily favors the Warsaw Pact. On the basis of this reassessment, the Allies can reach new agreements on precisely what the West needs to do, how to do it, and how much each Ally should contribute. Through this orderly process you can begin the process of getting NATO ready to meet the challenges of the years ahead.

It will also be important, early in your Administration, to make clear to Japan how you want to proceed with basic political relations. Since these have been damaged by economic strains, a new basis of trust needs to be created, with a priority placed on common political interests. The Japanese, in our view, are likely to be receptive to your positive overtures.

We do not believe it is in the U.S. interest to press Japan to make further increases in its defense spending. But we do believe Japan should be challenged to do more with its growing economic might to further broad Western security interests. It would be far better for all concerned, we believe, for Japan to make its contribution in increased foreign aid and untied trade assistance and debt relief to Third World countries.

Getting Rid of the Budget Deficit: Why We Should and How We Can

Thomas E. Mann and Charles L. Schultze

Almost as if by mutual agreement, both presidential nominees had little to say during the election campaign about how they would deal with the huge and persistent federal budget deficit and the fall in national saving and capital accumulation it has caused. Both George Bush and Michael Dukakis put forth what they described as "solutions" to the saving and deficit problem — Vice President Bush, a "flexible expenditure freeze," and Governor Dukakis, stricter enforcement of the tax laws. These plans, designed so they would not alienate any group of voters, are judged by most independent observers to be as ineffective as they are inoffensive. Moreover, since neither candidate apparently felt assured that his own approach to the deficit could withstand attack, little of the campaign debate centered on ways to eliminate the deficit.

We believe that the dearth of national saving and capital accumulation, and the budget deficits that are its principal cause, constitute America's most pressing economic problem. We hope that despite the paucity of campaign discussion about how to handle this problem, the new president will soon be of the same mind. And so we outline the reasons for our concern and offer several suggestions about how he might go about the essentially political task of securing public and congressional support for the measures needed to get rid of the deficit.

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Stability Is Not the Main Problem

Traditionally, political debate about America's economic performance centers on questions of economic stability — unemployment, recession, and inflation. In these dimensions, the economy has performed quite well ever since the recession of 1981–82, despite the unprecedented increases in the U.S. budget and trade deficits and large swings in both interest and exchange rates. Given the high level of those deficits and the uncertain course of the dollar, preventing recession or a renewal of inflation — the two principal forms of instability — remains a major challenge. Nevertheless, with a little bit of luck and careful management of economic policy, especially by the Federal Reserve, the odds are reasonably good that both recession and worsening of inflation can be avoided (see p. 23).

Recession and inflation, however, are not the only economic problems a nation faces. A successful economy must also make provision for the future. It ought not to consume, through either private or government spending, all of its current production. On the contrary, it should save a reasonable fraction of that income to invest in expanding the nation's productive wealth. The country's capital stock must increase simply to provide a growing labor force with an undiminished amount of capital per worker; otherwise the productivity of the labor force

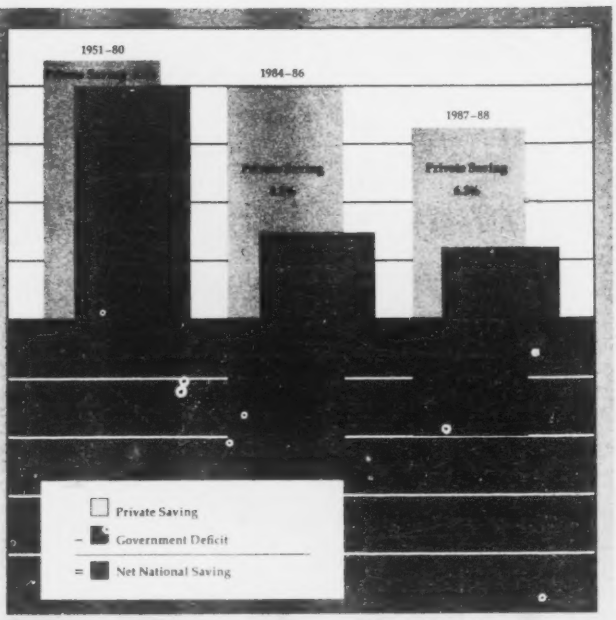
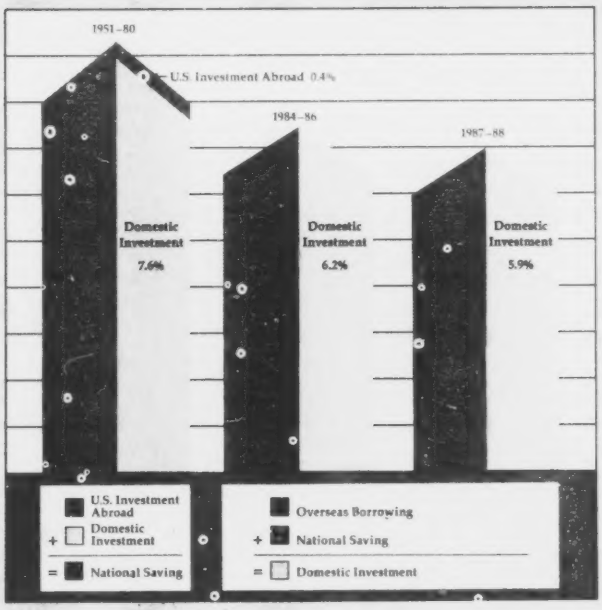


Figure 2. Financing U.S. Domestic Investment
(as a percentage of net national product)



Notes: 1988 data is for the first half of the year only. Surplus in state and local social insurance funds (mainly pension funds of state and local government employees) is classified as private saving.
Source: Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts.

might actually decline. Further additions to the stock of national wealth are necessary to raise productivity and advance the nation's living standards. Because advances in technology are usually incorporated in the production process through the purchase of new machinery and equipment, a country that sharply cuts its rate of investment in new capital is also likely to stagnate technologically as the rest of the world moves forward. And if its citizens are to enjoy the fruits of capital accumulation, the United States needs to finance that accumulation out of its own saving, rather than borrowing heavily from abroad and paying interest and dividends to foreigners, as we have been doing recently.

With respect to this highly important aspect of economic performance — the national rate of saving and wealth accumulation — the United States has slipped backward considerably in recent years. It is to the difficult task of remedying this failing that the new president should give his immediate attention.

The Collapse of National Saving

National saving consists of two major components — private saving and government saving. Government saving is the budget surplus. Conversely, a budget deficit *reduces* national saving, because an equivalent amount of private saving is diverted to finance the government deficit, leaving that much less available for national investment. The U.S. national saving rate has fallen dramatically in recent years, dropping from 8 percent of net national product during the first three decades of the postwar period to 3½ percent in the first half of the 1980s and to a mere 2½ percent in the last two years *(see figure 1)*. Both government and private saving declined. The private saving rate dropped by about three percentage points, to a low of 6 percent in 1987–88. And the government budget deficit, which represents national *dis*saving, rose from a 1951–80 average of slightly more than 1 percent of net national product to more than 5 percent in 1986, falling back to 4 percent in 1987–88 as some progress was made on the deficit.

The deficit grew for several reasons. The large tax cut of 1981 stimulated additional consumer spending, and the defense buildup of the early 1980s was not fully offset by cuts elsewhere in the budget. The deficit was further exacerbated by high real interest rates that had to be paid on the rapidly rising public debt. In short, throughout the 1980s, the United States has been on a spending spree, raising the proportion of its income devoted to private consumption and government spending and correspondingly decreasing the portion of income it saves for the future.

Had the United States relied on its own national saving, domestic investment would also have fallen to only a little more than 2 percent of net national product. But because of the high U.S. interest rates and foreign investors' assessment that the United States is a safe place to invest, it was able to finance much of its spending spree by borrowing from abroad on a grand scale, rather than by eliminating almost all investment here at home. Thus, domestic investment in housing construction and business plant and equipment fell by only two percentage points, despite a 5½ point decline in the national saving rate *(see figure 2)*. In the process, the United States, which in earlier years had generally been a net investor overseas, became a major net borrower in overseas markets.

The financing process worked as follows: the sharp increase in federal borrowing, added to the normal borrowing requirements of the private sector, drove up interest rates; the United States became an attractive place for foreign investors to put their money; the consequent increase in the demand for dollars raised the dollar's exchange value with other currencies, depressed American exports, and expanded imports. The net result was a huge trade deficit and a large inflow of foreign saving into the United States.

Foreign borrowing, however, will not allow the United States to escape the consequences of the drop in its national saving rate. Had the United States adjusted to that lower saving rate by radically cutting domestic investment in productive assets, the future growth of American living standards would have been depressed by slowing productivity growth. Having adjusted to lower saving by borrowing from abroad, U.S. living standards will suffer for a different reason — a continuing portion of our future income will go to foreign investors in the form of interest payments on the massive overseas debts.

The President's Choices

The overspending by consumers and government continues. The new president faces the task of deciding what to do about it. With the dollar still well below the highs it reached several years ago, U.S. exports are booming and the U.S. trade deficit is declining. Correspondingly the inflow of foreign saving into the United States is shrinking. To keep the trade deficit moving down, the economy has to produce, within the limits of its slowly growing industrial capacity, more exports and more domestic substitutes for imports. To make room for that production without seriously overheating the economy, domestic demand must be reined in.

The president has only two real choices: he can reduce the budget deficit to slow down domestic spending and raise the national saving rate, or he can let the Federal Reserve curb spending through a restrictive monetary policy. If he opts for the first alternative, the growth of consumer spending could be reduced by a tax increase and the growth of government spending could be pared back. Interest rates would then fall, reflecting lower federal borrowing. Lower interest rates, in turn, would produce a lower overseas value for the dollar and hasten the decline of the trade deficit.

Because private saving has also fallen, eliminating the budget deficit alone would not return the national saving rate to pre-1980 levels, but it would go a long way in that

direction. The American economy would begin to accumulate wealth again at a more normal pace, both because borrowing from overseas would diminish and because the rate of domestic investment would increase. The threat to the future growth of the nation's living standards represented by the abnormally low saving rates of the recent past would be, if not eliminated, at least substantially reduced.

The other alternative open to the new president is to pay only lip service to elimination of the budget deficit, abdicating to the Federal Reserve the task of cutting back the excessive growth of spending through tight money and high interest rates. Indeed, the inflationary threat from excess spending forced the Federal Reserve to begin the process of raising interest rates in the summer of 1987. That process was interrupted after the October stock market crash but resumed again in 1988.

A continuation of that process, however, would have three unwanted consequences. First, high interest rates depress investment spending more than consumer spending. Second, because they also tend to raise the value of the dollar, high interest rates would slow or even halt the decline in the U.S. trade deficit that is now under way, force the United States to continue its heavy reliance on borrowing from abroad, and thereby increase still further the already mounting burden of foreign debt service. Third, the necessity to pay higher interest on the public debt would increase government spending and exacerbate the deficit problem.

Thus, failure to use deficit reduction to slow the growth of domestic spending would perpetuate the nation's extremely low saving rate and the depressed rate of net capital accumulation that goes with it. The consequences will be highly unwelcome, but they may well not appear in the obvious and politically unpalatable form of recession or inflation. Instead, they will be much harder to discern, taking the form of a real, but year-by-year and almost imperceptible, slowing in the growth of American living standards. Therein, as we shall see, lies a major political problem.

The Size of the Deficit Problem

Ideally national policy ought to aim not just for a balanced budget but for a surplus. America faces a long period in which the number of retired people will grow steadily relative to the size of the working population *(see box, p. 8)*. To avoid placing an undue burden on future generations, the current labor force should be saving for its later retirement, investing the funds in productive assets that will provide the extra income to support that retirement. The national saving rate therefore should be increasing, not decreasing.

The Social Security Factor

Congress moved in 1978, and again in 1983, to restructure the nation's public retirement program, Social Security, so that the baby-boom generation of workers would in fact finance its own Social Security retirement benefits. The tax schedule was set high enough to ensure that the Social

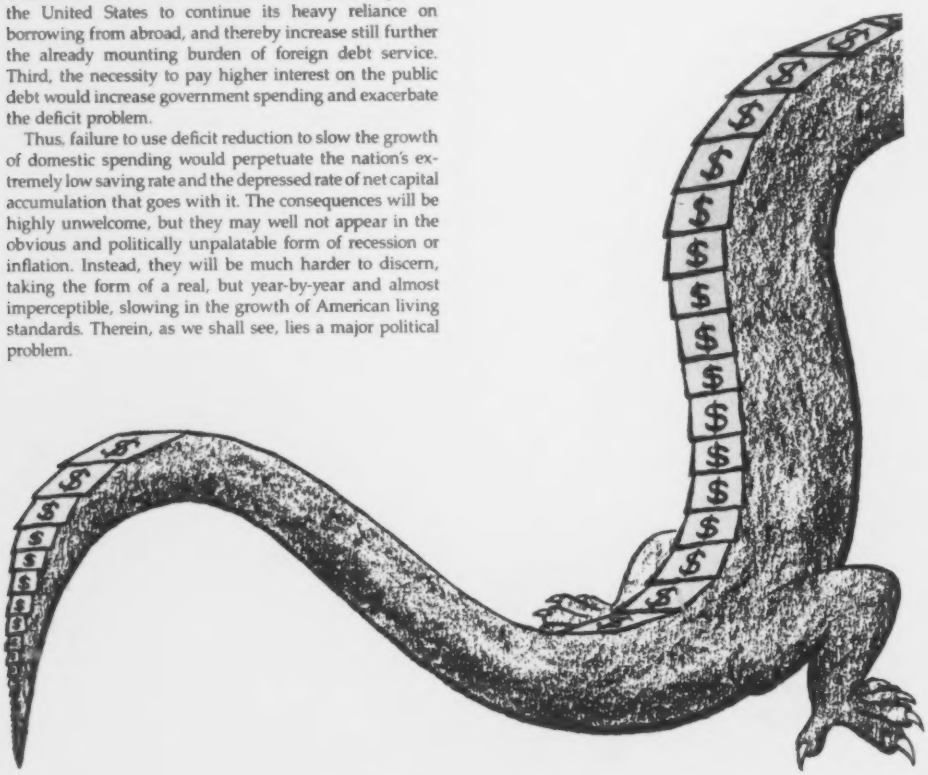
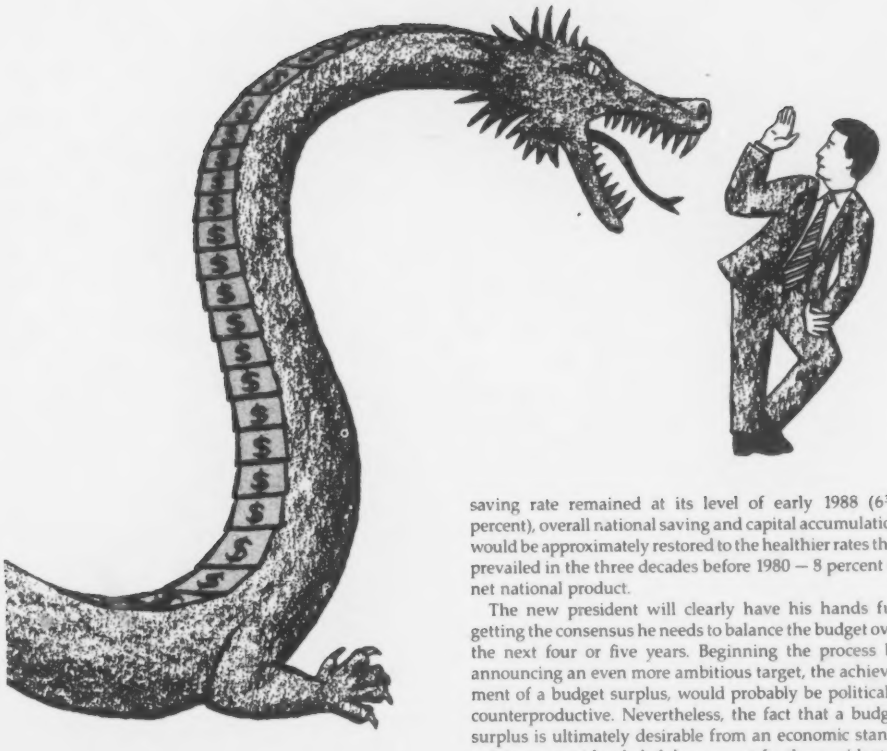


Illustration by Robert Weber



Security trust funds will run increasingly large annual surpluses through the rest of this century and into the next, to accumulate funds and invest in assets to help pay the benefits. In fiscal 1988 the trust funds had an excess of revenues over expenditures of some $40 billion; by 1993 that annual surplus will grow to about $100 billion.

The funds are invested in federal government securities. But the mere accumulation of federal securities in an earmarked trust fund does not itself help the nation accumulate additional productive assets for the future. To do that, the country must increase its national saving by an amount equal to the surplus in the Social Security trust funds. Accordingly, the federal budget, which as conventionally defined includes the Social Security funds, should in the long run aim at a *surplus* equal to the surplus in the Social Security funds. (Equivalently, the budget outside of Social Security ought to aim for long-run balance.)

Ideally, by the mid-1990s the federal budget ought to produce not merely balance but an overall surplus in the neighborhood of $100 billion a year, or about 1½ percent of GNP. If that goal could be achieved, while the private saving rate remained at its level of early 1988 (6¾ percent), overall national saving and capital accumulation would be approximately restored to the healthier rates that prevailed in the three decades before 1980 — 8 percent of net national product.

The new president will clearly have his hands full getting the consensus he needs to balance the budget over the next four or five years. Beginning the process by announcing an even more ambitious target, the achievement of a budget surplus, would probably be politically counterproductive. Nevertheless, the fact that a budget surplus is ultimately desirable from an economic standpoint can provide a helpful argument for the president to counter those who say the country can live with the current deficit.

Projections Too Optimistic

According to the latest estimates of the Congressional Budget Office (CBO), the budget deficit, which will run in the neighborhood of $150 billion this fiscal year, may fall to about $120 billion by 1993. This estimate is for a "current services" budget, which assumes that tax laws remain unchanged, that spending for defense and discretionary civilian programs increases only to the extent necessary to keep up with inflation, and that spending for entitlement programs such as Medicaid and veterans' benefits proceeds in accordance with laws already on the books. The CBO estimate also assumes, with modest optimism, that the economy grows at a steady rate of a little under 2½ percent a year without recession and that inflation remains near today's rate of about 4 percent a year. The CBO projection assumes that the unemployment rate creeps up gradually to 5.7 percent by 1993. The budget office uses this estimate, rather than a more ambitious level nearer 5 percent, because on the basis of historical experience, the economy

cannot be expected to run year after year at its full potential. And so, the CBO argues, prudent estimates of further budget outcomes ought to allow, on average, for a small amount of slack. Because the overall budget includes the Social Security funds, the estimated 1993 budget deficit of $120 billion consists of a $100 billion *surplus* in the Social Security funds and a $220 billion *deficit* in the rest of the budget.

The CBO projection is too optimistic in two ways. First, CBO assumes a significant drop in interest rates (it expects, for example, that the rate on long-term Treasury securities will decline from its current level of almost 9 percent to 7.6 percent by 1994). But if future budget deficits are actually as high as $120 billion, inflation is at the assumed level of 4 percent, and the inflow of funds from abroad continues to shrink, interest rates are unlikely to be much if any lower than they are today. And each percentage point increase in interest rates above the level assumed by CBO eventually adds some $25 billion to the annual deficit estimate.

Second, Congress, under pressure to hold down the budget deficit, has for the last seven years kept civilian

How Social Security Affects the Deficit

Social Security — Old Age, Survivors, and Disability Insurance — provides pensions to eligible workers who become disabled or retire and to their dependents and certain survivors. Workers acquire eligibility by employment in jobs subject to the payroll tax, currently 12.12 percent on earnings up to $45,000 a year, levied half on employees and half on employers. The tax rate is scheduled to rise to 12.4 percent in 1990. Current law provides for no further increase in payroll tax rates, although the wage base is increased annually in line with the rise in average earnings.

The Congressional Budget Office estimates that Social Security outlays for benefits and administrative expenses will total $203 billion in 1988, $39 billion less than projected revenues of $242 billion. That surplus is projected to swell to $113 billion by 1994 and to keep rising for many years.

In the late 1970s the Social Security trust funds faced serious deficits. The shortfall in 1980 was $1 billion, and experts projected huge deficits once the large baby-boom generation began to draw its retirement benefits starting around 2010. As a result, Congress in 1978 and again in 1983 restructured the payroll tax, setting it high enough to build up a large surplus in the trust funds over the next four decades.

This approach forces members of the baby-boom generation to pay in enough taxes to cover their own benefits. The economic objective of the surplus is to increase national saving, raise the rate of capital accumulation, and thereby boost the capacity of the economy so that future workers will not be made worse off when the proportion of beneficiaries to workers rises.

Under budget conventions, Social Security taxes and benefits are lumped together with all other receipts and outlays of the federal government. Thus, a *surplus* in the Social Security trust funds *reduces* the overall federal deficit. Far from adding to the growing federal budget deficits that have emerged since 1980, the Social Security system has counteracted even larger deficits on the rest of government operations *(see table)*. The projected drop in the overall deficit occurs entirely because of the considerable rise in Social Security surpluses. Indeed, the deficit on other operations of government is projected to increase.

In short, Social Security is not part of the federal deficit problem. Cuts in benefits would be justified only if benefits are larger than is appropriate. Three arguments have been advanced to justify benefit cuts.

First, the elderly, long an economic underclass, have achieved approximate economic parity with younger Americans. Because averages conceal serious inequalities within each group, however, benefit reductions should not adversely affect particularly vulnerable segments. Furthermore, since the economic parity of the elderly is traceable in large measure to increased Social Security benefits, basing benefit cuts on the economic gains of the elderly would be self-contradictory.

Second, life expectancy has increased, suggesting to some that American workers should continue to work longer than has been customary. In fact, the average retirement age has been falling.

Third, Social Security benefits currently are treated far more favorably under the personal income tax than are other pension benefits.

Three classes of proposals for cutting Social Security benefits have been mentioned as possible components of a deficit reduction package.

Cost-of-Living Adjustments. COLAs could be suspended or capped. Temporary suspension of such adjustments is equivalent to an across-the-board cut in benefits for everyone, regardless of economic status. A one-year suspension would reduce benefits about $10 billion a year. Suspending the COLA only on benefits above a particular level would be difficult to administer.

Limiting the COLA to two percentage points below the inflation rate would reduce outlays about $8 billion in 1991, $23 billion in 1994, and more thereafter. Permanently limiting cost-of-living adjustments, for example, to the rate of inflation less 2 percent, is equivalent to revising the Social Security benefits formula from one that

budget programs under considerable restraint. Funds for some functions of government have been squeezed to a level that probably ought not to be sustained — pollution control, investment and operating expenses for national parks and forests, and worker training programs are examples. And pressures for new or enlarged programs (or for tax breaks to support "social" objectives) are mounting. Among these are day care, a space station, health insurance for those who are neither eligible for Medicaid nor satisfactorily covered by employers, and renewed funding for public housing *(health insurance, see p. 32; housing, see p. 34)*.

While the tendency will be to finance as many new initiatives as possible either with new sources of dedicated revenues or by mandating expenditures from private employers, some of these activities will have to be funded in ways that enlarge the deficit. The added budgetary costs will not be dramatic, but they are likely to be substantial — on the order of $10 billion–$15 billion a year. In addition, the costs of dealing with the problems of federally insured deposits in ailing savings and loan institutions, especially in the oil-dependent states of the Southwest, will run very

Federal Budget (Billions of dollars)	1980	1988	1994	Change 1980–88	Change 1988–94
Balance including Social Security funds	$–74	$–155	$–121	$–81	$ 34
Social Security funds	– 1	39	113	40	74
Balance excluding Social Security funds	–73	–194	–234	–121	–40

Source: Numbers for 1980 are actual. Numbers for 1988 and 1994 are Congressional Budget Office baseline projections.

ensures recipients benefits of constant purchasing power throughout their lives to one that ensures them continually declining benefits the longer they live or remain disabled.

The "Retirement Age." Workers must reach the age of 65 before they are eligible for full Social Security benefits. Retirees may claim actuarially reduced benefits after reaching age 62, and most, in fact, do. Because of the actuarial reduction, the long-term cost of benefits for those who retire before age 65 approximates that of workers who claim unreduced benefits at age 65. Increasing the age at which workers become eligible for unreduced retirement benefits could lower outlays materially.

In 1983 Congress provided for a gradual increase in that age limit to 67 starting in 2003. That increase could begin sooner and the age could be increased beyond 67. While the long-run budgetary implications of such a change are large, the short-run effects are likely to be small, as Congress would be unlikely to begin such an increase immediately and would phase it in gradually.

As part of a deficit reduction package, large cuts in benefits raise a knotty dilemma. Social Security is financed by a payroll tax specifically set to cover projected benefits. The most recent actuarial projections indicate that Social Security is in "close actuarial balance," a term of art that means that revenues projected over the next 75 years are at least 95 percent of projected outlays.

As we have noted, current revenues greatly exceed current outlays. If benefits were to be cut significantly, the excess of current payroll taxes over current outlays would increase, and the system would be overfinanced, according to the projection methods now in use.

If payroll taxes were unchanged, the effect of benefit cuts would be to increase the degree to which Social Security surpluses offset deficits on other government operations. But payroll taxes are highly regressive because they exclude earnings over the wage ceiling, currently $45,000 annually, and few people would find this tax a fair way to pay for the general operations of government.

On the other hand, if payroll taxes were cut in line with benefit reductions, the changes would do nothing to reduce the overall deficit. Only if such cuts in payroll taxes made it possible to increase some other tax, such as the personal income tax, would a balanced reduction of Social Security benefits and taxes contribute to deficit reduction.

Taxation of Benefits. Currently, half of Social Security benefits are included in income subject to personal income tax to the extent that income exceeds $32,000 for couples and $25,000 for single persons. In contrast, all private pensions are subject to tax unless they represent the return of premiums paid out of after-tax income by the worker. Application of the same principle to Social Security would require repeal of the income thresholds and inclusion in taxable income of about 85 percent of all benefits. Such a change would boost revenues by about $15 billion in 1989.

Senior fellows ***Henry J. Aaron, Barry P. Bosworth, and Gary Burtless*** *are the authors of the forthcoming Brookings book,* Can America Afford to Grow Old? Paying for Social Security.

much higher than the current budget projections assume (see p. 36). Large additional amounts of federal budgetary resources will be required. A conservative estimate of the 1993 budget deficit, in the absence of major actions to correct it, would be in the neighborhood of $140 billion to $150 billion. (Because the economy will be growing, a budget deficit that remains at about $150 billion will absorb a declining fraction of net national product. But if the rising surplus in the Social Security accounts is excluded, the deficit in the remainder of the budget, as a share of net national product, will fall only slightly, from 4.6 percent in 1988 to about 4.2 percent in 1993.)

Can Growth Eliminate the Deficit?

The faster the growth of the economy, the faster the growth of federal revenues. The CBO projection assumes that the growth of national output averages a little under 2½ percent a year between now and 1993. Is it possible that this estimate is substantially too pessimistic and that with more expansive economic policies — especially an easier monetary policy by the Federal Reserve — economic growth could be speeded up enough to eliminate the deficit over the next four or five years?

There are two kinds of economic growth. When an economy has much unused capacity and a high unemployment rate, as is the case during and immediately after a recession, it can grow much faster than its long-run growth potential, simply by putting idle workers and factories back to work. Once the economy has recovered to the level of its practical capacity, however, output can grow only as fast as capacity expands. At that point, expansive monetary or fiscal policies that seek to stimulate the growth of national spending faster than the growth of capacity will generate inflationary pressures, as consumers, governments, exporters, and investors attempt to buy more goods than can be produced.

The U.S. economy is now approaching the practical limits of its existing capacity, or productive potential. Economists do not know at exactly what point falling unemployment begins to generate inflationary wage gains. But historical experience and the demographic characteristics of the current U.S. labor force suggest to many of them that inflation will go up if the rate is pushed below 5 percent. Similarly, the manufacturing industry is running at about 84 percent of capacity, modestly below levels that in the past have signaled rising industrial prices. Perhaps a little slack remains to be taken up, but the U.S. economy cannot be expected to grow for any sustained period significantly faster than the growth of its potential or capacity output.

The growth of an economy's potential output is determined by a combination of two factors: how fast the work force grows and the growth of output per worker. Over the next five years or so the U.S. labor force will grow a little less than 1½ percent a year, according to projections of the Bureau of Labor Statistics. Estimating the growth of productivity is a more difficult matter. Starting in the late 1960s output per worker, which had been rising at some 2½ percent a year, began to grow more slowly. A further slowdown occurred after 1973. And during the past eight years output per worker grew at an average of a little under 1 percent a year.

". . . any effort, through an easy money policy, to stimulate growth of this magnitude would yield neither higher growth nor a balanced budget, but substantial inflation almost surely followed by recession."

Despite extensive research on the causes of the decline in productivity growth, which also occurred in other industrial countries, only a small part of the drop can be explained. Since no one knows why productivity growth slowed, no one can be certain what it will do in the future. Nevertheless there is no basis for making budget plans on the assumption that after 15 years of slower growth, productivity will suddenly accelerate. As a consequence, most projections of the growth of U.S. economic potential estimate that output per worker will continue to grow a little under 1 percent a year for the next few years. Coupled with a labor force growing a little less than 1½ percent a year and with a small allowance for taking up the slight amount of slack remaining in the economy, that yields a projected GNP growth of a shade over 2½ percent, a little higher than the CBO estimate, but not much. Actually realizing such growth for the next five years, without interruptions, would itself be quite an accomplishment, and as the CBO points out, a prudent estimate based on historical experience would not be that optimistic.

The CBO projections, together with the other assumptions outlined here, would produce an estimated budget deficit of $140 billion–$150 billion in 1993. It would take five years of economic growth of at least a percentage point a year higher than the CBO projection to generate a balanced overall budget by that year. Such a sustained growth rate is well beyond the bounds of the possible, and

any effort, through an easy money policy, to stimulate growth of this magnitude would yield neither higher growth nor a balanced budget, but substantial inflation almost surely followed by recession. The United States cannot grow its way out of the budget deficit.

What It Will Take to End the Deficit

In analyzing the federal budget, it is convenient to break expenditures into four major components, whose estimated 1988 magnitudes are: defense, $293 billion; Social Security and Medicare, $299 billion; interest payments, $151 billion; and all other, $320 billion.

Interest payments on the debt cannot be reduced by act of Congress. Other budget cuts, however, do slow the growth of the national debt and in that way lower projected interest costs. Elimination of the budget deficit would tend to bring down interest rates, which would also lower budget outlays for interest. On the other hand, CBO projections that underlie the deficit estimates given here already assume some decline in interest rates, even though such a decline would be unlikely without substantial deficit reduction.

On balance, however, the president and Congress can count on some interest "bonus" from budget-cutting measures. Any combination of tax and expenditure measures that took effect gradually and by 1993 amounted to about $100 billion a year would provide an interest bonus of about $40 billion–$50 billion annually, enough to balance the overall budget. A more ambitious program of tax increases and expenditure cuts that amounted to $150 billion a year by 1995 would, because of the bonus, convert a $150 billion deficit into a *surplus* somewhere around $100 billion, still less than that year's expected surplus in the Social Security trust funds.

Possible Spending Cuts

After several years of steep increases in defense spending, a consensus seems to have emerged recently among Republicans and Democrats in Congress that the inflation-adjusted level of defense spending ought to stay near current levels; the remaining debate centers on whether it should rise or fall a little each year. Barring a major breakthrough in negotiations with the Soviet Union on conventional force reductions, a major deficit-paring program might cut $15 billion, perhaps $25 billion, out of the Pentagon's budget by 1993, but not much more.

Neither of the two political parties seems at all inclined to reduce Social Security benefits. Even if they were, a benefit cut would simply increase the already large annual surpluses in the fund, an increase that would offset deficits elsewhere in the budget. Since Social Security is financed by a highly regressive payroll tax, it seems highly inequitable, and even more politically unpalatable, to use that tax to finance deficits in the general operations of the federal government.

Social Security beneficiaries do, however, receive very special tax treatment on their Social Security income. They pay taxes only on half of their benefits, and then only if their total income is above a certain level. The rationale for the 50 percent exclusion is that beneficiaries, during their working lives, already had paid federal income taxes on their own payroll contributions to the Social Security funds. In fact, however, the typical beneficiary during his or her working life will contribute in payroll taxes far less than 50 percent of the retirement benefits he or she ultimately receives.

If Social Security benefits were taxed the same as benefits under private contributory pension plans, only about 15 percent would be excluded from taxable income. If the Social Security exclusion were reduced to 15 percent and if the income threshold were removed, the revenue increase would amount to about $20 billion a year by 1993. Under this approach, and unlike suggestions for across-the-board benefit cuts, the contribution of retirees toward deficit reduction would be related to their income, and because of the way the tax system works, low-income elderly would be exempt. The proceeds from the tax should be put into general revenues to help reduce the deficit, and should not, as is now the case, be earmarked for the Social Security trust funds.

Several measures have been taken in recent years to try to slow the growth of hospital and physician charges under Medicare, and some contributions from elderly beneficiaries have been increased. Additional savings may indeed be possible here, but, again, they are unlikely to be large. Because the number of beneficiaries is increasing and because medical care costs are rising much faster than inflation, Medicare outlays are scheduled to rise from their 1988 level of $87 billion to almost $150 billion in 1993, some $40 billion more than a simple adjustment for inflation. Thus any attempt to hold Medicare expenditure growth to the rate of inflation, implicit in proposals to freeze overall outlays, would involve huge and politically unjustifiable cuts in services for elderly beneficiaries.

Measured by number of activities rather than dollars spent, the "all other" category covers most of what the federal government does. It runs the gamut from the financing of medical care for the poor (Medicaid), to operating the FBI, to fighting the drug war, to providing student loans. All of these activities and programs now amount to some $320 billion, less than a third of the total budget. Congress and the president have already made substantial cuts here. In 1966, before President Johnson's Great Society programs had really gotten underway, the all-other category was 6.3 percent of GNP. By 1980 it had risen to 9.5 percent of GNP. Since then it has been steadily whittled down to 6.7 percent, close to what it was before the expansion. Undoubtedly some further cuts could be negotiated in selected programs in this group. But because they constitute only one-third of the budget and their relative size has already been reduced to what it was 20 years ago, achieving budget balance from further cuts in these programs seems both politically infeasible and substantively questionable.

Tax Increases: Choosing Among Four Broad Options

Should the new president decide to seek an increase in taxes, he will be forced to choose from among four broad options.

Option One

Raise Income Tax Rates. **The Tax Reform Act of 1986 significantly broadened the personal and corporate income tax bases. As a result, small increases in rates yield considerable revenue. An increase of one percentage point in personal and corporate income tax rates would bring in about $24 billion in 1989. Increasing personal tax rates, currently 15 percent and 28 percent, to 18 percent and 31 percent would raise revenues by about $74 billion in 1990 and by $89 billion in 1993.**

The chief argument for using this option to raise taxes is that the tax reform law significantly increased the fairness of the personal and corporate income tax bases. The chief argument against this option is that Congress would be forced to reexamine some 1986 decisions it might prefer not to revisit. The most important of these involves the preferential rate for long-term capital gains, which was abolished in 1986. A rate increase would intensify pressure either to restore this preference or to adjust for inflation, a proposal that Congress rejected in 1986.

Option Two

Broaden the Income Tax Base. **Despite the base-broadening of the 1986 act, large components of income still remain outside the personal and corporate tax bases. Adding them to the tax base would raise considerable revenue. The largest items and the additional revenues they would provide in 1989 are: exclusion from personal income tax of employer-financed fringe benefits other than pensions, $29.9 billion; individual deductions for non-business state and local taxes (other than property taxes), $17.3 billion; deductions for property taxes on owner-occupied housing, $10.4 billion; deductions for mortgage interest, $32.2 billion; and failure to tax unrealized capital gains at the death of the taxpayer, $4.5 billion. Taxing employer contributions to pensions would yield $15 billion a year.**

In 1983 Congress authorized the taxation of half of Social Security benefits for single beneficiaries to the extent that their annual income exceeds $25,000 ($32,000 for couples). Increasing the proportion of such benefits to 85 percent (a proportion that would make taxation of Social Security benefits similar to that of private pensions) and elimination of the income thresholds would raise revenues by about $15 billion in 1989.

The chief argument for subjecting these items to tax is that each should be included in the tax base if the objective is a comprehensive income tax. The chief argument against these reforms is a political one. Congress has repeatedly rejected some of them and refused even to consider others.

Need for New Taxes

A review of the possibilities for spending cuts thus reveals that while some further reductions are possible, a serious effort to eliminate the budget deficit must include sizable revenue increases. Of the $90 billion–$100 billion in deficit reduction actions estimated to be necessary for balancing the budget, it is unrealistic to expect that more than $25 billion–$35 billion in expenditure cuts could be enacted. That leaves a minimum requirement for some $55 billion–$75 billion in new taxes. Even larger increases would be required if the budget is to be balanced without relying on the Social Security surpluses.

Modest contributions to this total might come from increases in the "sin" taxes on tobacco and alcohol. But even a 50 percent increase in these taxes would bring in only about $6 billion. In theory, the base of the income tax might be broadened by removing some additional deductions and exemptions. But the country has just gone through a major tax reform and, in any event, the large deductions that remain — for residential housing and for state and local income taxes — benefit not only the "rich" but also the broad range of middle-class Americans. Thus picking up much revenue from this source is likely to have little political support.

Some people might prefer to try to generate most of the revenue from additional taxes on the rich. But it would be impossible to raise the amounts necessary without raising marginal tax rates so much as to impair incentives seriously. Moreover, large increases in tax rates at the upper end of the income scale would begin to generate pressures to recreate the special lower tax rate for capital gains; eliminating that special rate was a major accomplishment of the 1986 tax reform, and an important element in reducing tax shelters.

As noted, a relatively substantial revenue gain, as much as $20 billion a year, could be realized from reducing the income tax exclusion of Social Security benefits from 50 percent to 15 percent and eliminating the income threshold. Politically, the only conceivable way that might be done is in the context of an overall budget reduction plan under which every element of society, except the poor, shares the cost. Both budgetary analysis and political realism suggest that any feasible plan to eliminate the budget deficit will have to include a large increase in revenues from one or more of the following sources: a broad-based increase in income taxes; a tax on gasoline and perhaps other forms of

Furthermore, proponents of existing law claim that each exclusion promotes some form of desirable behavior by the affected taxpayers. Should some reduction in Social Security benefits emerge as an essential component of a deficit reduction package, many commentators view increased taxation of Social Security benefits as the most equitable way to achieve that reduction.

Option Three

Impose a Broad Consumption Tax. For at least a quarter of a century various groups have argued that the United States should adopt a broad consumption tax, similar to the value-added tax used throughout the European Community and in many other countries. Because of the administrative burden of introducing a new tax, most analysts agree that it should be enacted only if it is to be used to generate large amounts of revenue, perhaps $75 billion or more annually. A value-added tax imposed on all consumption would yield about $20 billion a percentage point in 1989, about $12 billion if food, housing, and medical care were untaxed.

Option Four

Increase Excise Taxes. Increases in various excise taxes could generate added revenue, although not so much as the other options. Doubling excise taxes on all alcoholic beverages would yield about $4 billion in 1989. Tripling tobacco taxes would yield just under $6 billion. Several different taxes on the use of energy have been proposed. A 5 percent tax on all uses of energy would yield $14 billion a year. A $5-a-barrel tax on all petroleum consumption would yield $18 billion. The same tax limited to imported crude oil plus a $7.50-a-barrel tax on imported refined petroleum products would yield $7 billion. A tax of 10 cents a gallon on motor fuel would yield $10 billion.

The chief arguments for increases in taxes on alcohol and tobacco are that they would discourage consumption of harmful products and that inflation has sharply reduced real rates of tax. The arguments for taxation of energy, petroleum, or gasoline revolve around conservation and reduced dependency on foreign suppliers. Each of these taxes falls disproportionately on certain regions or groups. For this reason, fierce opposition in Congress comes from representatives of affected regions who allege that imposing uneven burdens is an unfair way to raise large amounts of revenue.

The president will have considerable choice among options if he wishes to raise a modest amount of revenue, say $25 billion to $50 billion. Small increases in income tax rates, modest increases in excises, and perhaps a modest broadening of the tax base could be easily combined to supply this amount of revenue. If the president should conclude that large revenue increases are necessary — say, $100 billion or more annually — fewer options are available. He would have to rely either on increases in the income tax rate or on a new broad consumption tax. He is unlikely to seek large amounts of revenue from base-broadening because of the entrenched opposition to each possible change. And increased excise taxes could supply no more than a minor fraction of the revenue sought.

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energy; and a new value-added tax, which is in effect a broad-based sales tax on consumer goods *(see box, p. 12).*

We do not attempt here to give an economic or political evaluation of these alternatives. But the central message is that a program to eliminate the budget deficit, and even more so, one that aims eventually to do it without relying on the Social Security surpluses, will have to include a package of tax increases that will be felt by a very wide range of the population — including the average taxpayer.

The Political Challenge

The new president faces a formidable political challenge. While some economists and financial leaders have for years been warning that large budget deficits would lead to catastrophe, none has occurred, and the public is growing immune to scare talk. Although far from guaranteed, the United States may be able to continue with large budget deficits and national overspending for another presidential term. The costs of failing to deal with the budget deficit are no less real for all of that.

But, as we have spelled out, they are gradual in nature, involving an almost imperceptible slowing year by year in the growth of American living standards. Like the fat person who needs to go on a diet but who feels that one more high-calorie meal won't hurt, Americans may rightly feel that one more year of high deficits will not itself cause grave damages. But continue the overeating, and the overspending, and long-term damage mounts up.

Unfortunately, the American political system is not well suited to address this challenge. While no democratic government can easily impose immediate sacrifices on its populace for the sake of future gains, the division of authority and responsibility between the president and Congress makes that task especially formidable in this case. In times of crisis, the government can move with breathtaking speed to change national policy; it can be equally responsive in the face of an insistent, unified citizenry demanding action from its elected officials. But political and institutional forces make it almost impossible for government to embrace austerity measures over the opposition of the public and with no promise of immediate gain or avoidance of disaster.

Some argue quite convincingly that the problem is simply too intractable for the government to resolve, that the political obstacles to the fiscal policy recommended

here make its adoption highly improbable. Consider those obstacles. The overarching reality is the gap between what the public apparently wants from its government and what it seems willing to pay. By most accounts, the public's demand for government services is rising rather than falling as the Reagan era draws to a close. Although they were careful to avoid specific commitments for large increases in outlays, both presidential candidates acknowledged during the 1988 election campaign that government would be asked to do more, not less, in the years ahead.

At the same time, there is no comparable support for an increase in taxes to finance those services. In 1987 the federal tax burden was 19.4 percent of national income, the same level as in 1980 and slightly higher than the norm in the previous two decades. By these standards, Americans have little reason to believe they are undertaxed. Yet the generous commitment of public funds to Social Security and Medicare and to the buildup of national defense, all of which enjoyed broad public support, combined with the rise in interest payments on the exploding national debt, has left us with substantially more government spending than that historical tax burden can support.

That the public strongly opposes closing the gap by raising taxes is no surprise. Public opinion polls have consistently demonstrated that fact. In fact, an asymmetry in public attitudes toward taxes and deficits normally makes it easier to avoid a revenue shortfall than to deal with one once it occurs. Citizens will forgo tax cuts to avoid a worsening deficit; they will not embrace a tax increase to undo an existing deficit. Before income taxes were indexed in 1985, politicians had the luxury of seeing revenues rise through bracket creep; they could raise tax dollars at the same time that they passed tax cuts. With that option no longer available, any increase in federal income taxes must be legislated explicitly and in opposition to the expressed wishes of the electorate. Setting aside the tax increases of 1982 and 1984, which primarily repealed provisions of the 1981 tax bill not yet fully in effect, the last peacetime increase in federal income taxes enacted by Congress was in 1932.

"The overarching reality is the gap between what the public apparently wants from its government and what it seems willing to pay. By most accounts, the public's demand for government services is rising . . . ."

The public's demand for at least the present level of government services and its opposition to increased taxes to pay for it is exacerbated by the pattern of party competition that has developed in recent years. Cutting taxes has become the touchstone of the modern Republican party; it is no exaggeration to say that low marginal tax rates may well be the most enduring political and substantive legacy of the Reagan presidency. Republicans who once preached balanced budgets and fiscal responsibility have cheerfully set aside their green eyeshades and embraced tax cuts as the engine of economic growth and opportunity.

Democrats, chastened by Ronald Reagan's effective use of the "tax and spend" charge and by Walter Mondale's failure to build support for a "responsible" tax increase in 1984, are eager to shed their identity as the party that raises taxes. The situation is exactly reversed on the issue of Social Security. The Democrats have hit paydirt in recent elections by portraying themselves as the champions of Social Security, repelling attacks on the system by the Republican party.

Each party is convinced that its greatest vulnerability is the other party's strength. Republicans feel especially vulnerable to charges that they are out to cut Social Security benefits, while Democrats fear being branded as the tax collectors of the welfare state. Consequently, Republican and Democratic officeholders feel obliged to innoculate themselves from these charges by taking irrevocable public positions in opposition to any tax increases or Social Security cuts. Over the past seven years this intensely partisan environment made efforts to reduce the deficit much more difficult.

The rhetoric of the 1988 presidential campaign was consistent with this pattern. George Bush exempted Social Security from his "flexible freeze" on federal expenditures and then flatly and unequivocally ruled out a tax increase. "I promise you, I'll not raise taxes as a first, second, or last resort," he said. That declaration was a reference to Michael Dukakis' assertion that he would raise taxes only if expenditure cuts and more rigorous tax enforcement failed to close the budget gap.

Each time the candidates addressed the deficit problem during the course of the campaign, they painted themselves further into a corner. Bush left no doubt that he would reject any recommendation for a tax increase that might be proposed by the National Economic Commission, the bipartisan body many politicians and economists hope will provide political cover for serious deficit reduction in 1989. While Dukakis did not rule out a tax increase if he found it absolutely necessary, his public posture during the campaign makes it difficult for him to embrace the revenue

"These political constraints should not be underestimated for even a moment. Yet several other developments may well improve prospects for the policies recommended here."

package that we have argued is necessary. Notwithstanding Senator Pat Moynihan's "law of opposites" (once in office, presidents do things least expected of them, often things they had explicitly promised not to do), what presidential candidates say during the campaign has consequences for their initial legislative program.

This partisan posturing on taxes and Social Security, with members of both parties eager to avoid blame for imposing or supporting austerity measures, has especially telling effects when the Republicans control the White House while the Democrats retain their grip on the Congress. With neither party fully responsible or accountable for fiscal policy, the incentive to pass the buck, to blame the other party and branch of government for the failure to balance the budget, often proves irresistible. (Divided government does not always work this way. The Tax Reform Act of 1986 is a good example of how under the right conditions divided government can muster bipartisan support for major policy change.)

The final obstacle to a bold move to reduce the deficit in the new administration is the easing of pressure to do something about it. One of the best kept secrets of the Reagan years is that the politicians on Capitol Hill were much more concerned about the deficits than the public was. Once it became clear in 1982 that the deficit was growing out of control, literally feeding on itself because of soaring interest payments on the debt, Congress took a number of difficult steps to contain costs and raise revenues. The cumulative effect was to lower the 1986 deficit by $162 billion.

This rather extraordinary achievement was made possible by a genuine fear among members of both parties that the economy would collapse under the weight of exploding deficits. Now that powerful motivating force is no longer present. Both deficits and the federal debt are projected to decline as a percentage of total national income over the next five years. The economy has performed well in recent years despite the unprecedented deficits and, as we have argued, it is reasonable to assume that the economy will continue to perform well in the near future. The temptation to declare victory and withdraw is hard to resist.

Encouraging Signs

These political constraints should not be underestimated for even a moment. Yet several other developments may well improve prospects for the policies recommended here. First, the public might be more accepting of a tax increase than a quick reading of the polls suggests. At the same time that it declares its opposition to increasing taxes to reduce the deficit, a majority of voters believes that the next administration will raise taxes. The uncertainty, even anxiety, that Americans feel about their future and their children's future is based partly on a nagging worry that today's success cannot be continued in the presence of a massive and growing national debt. Most citizens naturally favor lower taxes and prefer candidates who are not eager to raise them, but they also retain some old-fashioned views about balancing their accounts and providing opportunities, not burdens, to their children.

While it would be a mistake to declare the tax revolt of the late 1970s over, the context within which taxes are discussed today is vastly different from that of a decade ago. The burden of proof, to be sure, is still on those who would raise taxes to demonstrate that they will not discourage private investment and dampen economic growth, that they will make possible the provision of needed government services, that they are designed not to redistribute income but to improve the welfare of all citizens.

But even with those stringent requirements, governors and mayors across the country have been able to convince their constituents that tax increases can serve legitimate and desirable public purposes. Those experiences should provide a modicum of encouragement to a president who seeks to persuade the nation that the prospect of long-term gain justifies some immediate sacrifice.

Second, the utter exhaustion among the combatants in the seven-year deficit wars provides an opportunity for the new president. Deficit politics has commanded center stage throughout the Reagan administration; virtually all policy discussion has been fiscalized, with budgetary considerations overwhelming substantive ones. Members of Congress have been frustrated time and again when the fiscal rewards for politically painful budget cuts and revenue increases vanished overnight with revised economic and budget projections. When changes in the economy, especially in interest rates, had a greater effect on the budget than any efforts of their own, members of Congress were forced again and again to up the ante. Cutting programs and raising taxes in one year seemed only to feed the

demand for more spending cuts and tax increases the next. Budget reduction became an unending exercise that pushed everything else in Congress aside, and the failure to deal decisively with the deficit became a tacit admission that Congress was unable to govern. The prospect of continuing this exercise through the next administration is downright appalling to most of the participants. A reasonable and credible deficit package — even one with a tax increase — would have more appeal than the obvious political considerations suggest.

Other signs also indicate that a president intent on eliminating the deficit would not receive an inhospitable reception on Capitol Hill. While members of Congress certainly prefer raising expenditures and cutting taxes, rather than the reverse, congressional decisions on taxes and spending are not simply the sum total of 535 individual preferences. Historically, Congress largely follows the president's lead on fiscal policy, seldom raising overall expenditures or cutting taxes much beyond what he proposes (although often reordering his budget priorities). At various points, Congress has devised new institutional mechanisms to restrain the natural impulses of its members.

In the current era, the congressional budget process (especially its reconciliation process), omnibus spending measures, and strengthened party leadership have given Congress the capacity to engage in high-level budget negotiations and ensure the agreements at those summits are then implemented. The success of Congress in raising revenues in 1982 and 1984 and restraining discretionary domestic spending suggests that these new centralized decisionmaking procedures are not mere paper tigers.

If these developments make a deficit reduction package more politically feasible in the 101st Congress, they also underscore the point that little will be accomplished unless the new president takes the lead. Unless he is convinced that these steps must be taken, nothing short of an economic crisis can lead to any significant change in fiscal policy. Given both the campaign rhetoric on taxes and spending and the absence of any clear connection between deficit reduction and economic stability or political success, it is not easy to see how the new president will arrive at this position. But if he does, as we think he should, we believe his strategy for achieving these ends must be finely calibrated to the political and institutional realities that await him.

Even assuming his willingness to tackle the job, the new president faces a dilemma in how to go about it. On the one hand, his public popularity and influence over Congress are likely to be greatest in the months immediately after inauguration. That suggests that he should emulate the "blitzkrieg" model of immediate policy change used so effectively by Franklin Roosevelt, Lyndon Johnson, and Ronald Reagan. But unlike them, the new president cannot base his program on his recent victory at the polls. Election mandates are inherently subjective — more the result of politicians successfully selling their interpretation of the results than an objective reading of public opinion. Yet both the lack of candor in the presidential campaign about the remedies needed to deal with inadequate national saving and the absence of sweeping changes in the congressional elections make it virtually impossible for the new president to claim public support for bold and decisive action on the deficit. He is constrained both in what he can propose so soon after the campaign and in what he can get out of Congress.

A Strategy for Consensus

On the other hand, no modern president can afford to do nothing while he educates himself and the public on the nature of the challenge confronting the country. As Stephen Hess points out elsewhere in this issue, first impressions of presidents are often lasting ones — getting off to a fast start is essential for a successful first term and, most importantly, for reelection. Consequently, the new president must adopt a two-stage strategy. First, he should seek to win an early victory — a $35 billion down payment on deficit reduction that honestly meets the fiscal year 1990 Gramm-Rudman-Hollings target — that would give him some breathing room in which to position himself and prepare the public for the larger task. That down payment would itself have to include some tax increase, though conceivably made up of small bits and pieces along the lines President Reagan himself agreed to several times during his administration. The more substantial tax increase would await the second stage. In the second step — a year later — the president should propose a multistage deficit reduction plan that would, at a minimum, eliminate the remaining deficit by 1993.

No effort to eliminate the budget deficit over the next five years and eventually to build a surplus can succeed without providing some room for additional spending (or tax expenditures). The carrot as well as the stick will be needed to marshal support from the public and Congress to deal with the long-term problem of national saving. Where the additional monies should be spent (or revenues forgone) will properly be a matter of some contention. But the new president is well advised to plan on the government doing some new things as well as less of some old things.

In designing the second, and by far the larger, stage of deficit reduction that we have suggested, the administration should reach a "framework" agreement with congressional leaders on the numerical targets and the basic elements of the package (although not its details) before announcing any goals. Given the opportunities and incentives to avoid blame, care must be taken to keep the opposition party, individual members of Congress, and major interest groups from publicly disavowing the package when it is unveiled. The new administration may also find it desirable to seek bipartisan agreement before unveiling its plan to meet the 1990 Gramm-Rudman-Hollings target, the first stage of deficit reduction.

Finally, the new president must define the deficit reduction goals in a way that gives members of Congress

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some assurance that their political sacrifices will not be in vain if the economy performs less well in the short run than anticipated. Targets should be set for tax increases and expenditure cuts, and members of Congress should not be asked to approve more spending cuts and tax increases if a sluggish economy keeps the deficit from shrinking as rapidly as expected. Cooperation is likely only if an end to the deficit reduction game is in sight, which suggests that the long-range economic assumptions used to calibrate the budget plan should be realistic and not based on a "rosy scenario." The central players must not be asked for more, year by year. They must know what the game plan is and what they will be asked to do. In presenting his first-stage plan the new president should therefore be candid in letting Congress know that one more step will be forthcoming. He must also be credible in assuring the legislators that it will be the final step.

The challenge facing the leaders of the next administration is to convince the public and the political community to undertake some immediate sacrifices for the sake of future gains. To be successful, they will have to persuade their audience that the future gains are worth the current costs. Talking only of austerity, of reducing current consumption, is not likely to play well in Peoria or anywhere else in the country. The new president should sell his package by focusing on national saving and investment, economic growth and opportunity, competitiveness in world markets, and higher living standards for our children and grandchildren.

The deficit problem is primarily one of national saving and investment and the remedy must be sold largely in those terms. But presidents, members of Congress, and political parties must still build and maintain majority coalitions in the present. And so it is reasonable for them to look for some more immediate incentives to help lead their supporters in the desired direction. Providing some room for new governmental activity is essential.

We have one additional suggestion. In an era of adjustable-rate mortgages and home equity loans, the public is especially sensitive to increases in interest rates. The new president can reasonably and responsibly call for an implicit trade-off between fiscal and monetary policy — higher taxes and lower spending (producing a smaller deficit) will be rewarded with lower interest rates, certainly lower than they would be without the reduction in the deficit, and quite probably lower than they are now. The near certainty that the Federal Reserve would keep the contractionary effect of a tighter fiscal policy from slowing the economy would provide some immediate political payoff for what is a decidedly long-term job.

To sell a tax increase politically, the president and Congress will almost surely have to meet a final and difficult challenge. Numerous surveys have shown that Americans are willing to pay increased taxes for what they consider worthwhile purposes. In the case at hand, that means the public must be persuaded that a tax increase will be used to reduce the deficit, and thereby be an investment in the future, not a squandering of revenues now.

Simply earmarking a federal tax increase for deficit reduction would be a charade; so long as the higher revenues give the administration and Congress the leeway to spend more, new taxes will not reduce the deficit, whatever accounting fiction is used. To ensure public support, therefore, the president and Congress must provide credible assurance that any increased spending will not go beyond levels agreed upon in the deficit reduction package. There are no easy ways to make this guarantee, but several possibilities suggest themselves. The enactment of multiyear appropriations, which could be amended only by a two-thirds or three-fifths vote, might contribute to this end. Other procedural devices to "lock in" the initial spending agreements, and perhaps even to tie the tax increase to observance of those agreements, may need to be worked out.

Whatever the specific arrangements, two elements are essential: first, a decision by the new president to abandon his campaign rhetoric and tackle this country's most serious economic problem; and second, *a political* agreement between the president and Congress on the overall budget plan and its enforcement. While the 1987 budget summit disappointed many observers by failing to make greater progress on reducing the deficit, it did succeed in demonstrating that even under divided government a multiyear bargain between the two branches can be struck and implemented on Capitol Hill. It is to these new political tools, not the substantive disagreements that blocked more progress on the deficit, that the new president and Congress should look for the way out of the deficit.

THE BUDGET DEFICIT AND NATIONAL SAVING

Martin Feldstein

Professor of Economics, Harvard University
President, The National Bureau of Economic Research

Thank you, Mr. Chairman. I am delighted to appear again before this distinguished committee and to be here with you as its new chairman.

When I received your invitation, I recalled that I have been testifying about the budget deficit to the members of this committee since 1983. I warned then and on each subsequent occasion that large budget deficits are eroding our nation's capital stock and thereby slowing the growth of our standard of living. By raising real interest rates and therefore the value of the dollar, the budget deficit led to a massive trade deficit.

Last week's report that the trade deficit increased substantially in November is a reminder that the high value of the dollar is still a serious barrier to American competitiveness in world markets. And despite the decline of interest rates during the past several years, the real interest rates on longer term government bonds still remain twice as high as they were in the decades before 1980.

We have been fortunate during the past few years that the flexibility of the American economy in general and of our labor markets in particular has made it possible for growth to continue and unemployment to decline even though large sectors of the economy were depressed by the strong dollar and the high real interest rates. But there can be little doubt that the large trade deficit and the continuing dependence on foreign funds to finance our domestic investment in plant and equipment raise the risk of a "hard landing" in which soaring interest rates could cause a collapse of domestic activity.

The key point that I want to emphasize in my testimony this morning is that the budget deficit is part of a larger problem of a low national saving rate. What matters is not the budget deficit as such but the level of national saving. Reducing the budget deficit and increasing private saving are two alternative ways of achieving the same result. You and the other members of Congress should be asking not just: "What can we do to reduce the budget deficit?" but, more generally, "What can we do to raise the national saving rate?"

America's saving rate is shockingly low and has dropped dramatically in recent years. The substantial progress that has been made in reducing the budget deficit has been offset by the decline in private saving during the same period.

Let me review the facts for you. The budget deficit has declined from more than 6 percent of GNP at its peak in 1983 to 3.2 percent of GNP in FY1988. That budget progress was not an accident. Although some of that decline reflected the economic recovery and continued expansion, the deficit was also reduced by the tax increases of 1984 and 1987, by the sharp reduction in defense spending relative to GNP (from 6.3 percent in 1983 to 5.8 percent in the current fiscal year) and by modest reductions in some types of nondefense spending.

But despite this progress in reducing the budget deficit, the remaining large budget deficit means that the federal government is continuing to absorb half of all the net saving being generated by the rest of the economy, including the saving of households, firms, pensions, and state and local governments. And when the federal government borrows those funds, they are no longer available for investment in new plant and equipment or new housing.

The reason why the current budget deficit continues to absorb such a large share of private saving is that private saving itself has collapsed in the 1980s. The facts are really startling. In the 1970s, net private saving (including the saving

of households, businesses and state and local governments) was 9 percent of GNP. The federal deficit was 2 percent of GNP, leaving a net national saving rate of 7 percent of GNP. By last year the private saving rate was one-third lower than it had been in the 1970s, down to only 6 percent of GNP. And with the Federal deficit of 3 percent of GNP, the net national saving rate was only 3 percent of GNP.

A 3 percent of GNP net national saving rate is lower than in any other industrial country in the world. It means we are not doing enough saving to keep the stock of plant and equipment growing in line with the labor force and the stock of housing growing in line with the population. Without the current massive inflow of capital from abroad, we would see productivity decline and our housing stock deteriorate. And we cannot expect the inflow of foreign capital to continue indefinitely at anything like its current relative size. We as a nation must raise our saving rate or see our rate of investment decline and our standard of living stagnate.

A sensible approach to raising our nation's rate of saving should include both deficit reduction and improved incentives for private saving. In both of these approaches, you will find strong support from President Bush. He has emphasized his commitment to the goal of deficit reduction and has made several specific proposals to encourage increased private saving.

The key to successful deficit reduction is likely to be a new tougher Gramm-Rudman-Hollings procedure. The GRH process has been helpful in the past but it is losing its ability to force budget compromise or automatic spending reductions. A new tougher GRH would broaden the range of budget categories that are subject to automatic adjustment. Putting more on the table in this way would make the automatic procedure a more credible process that is less likely to degenerate into shifts of the budget target and other evasive maneuvers.

Legislating a credible multiyear deficit reduction plan with enough teeth to be reliable would automatically cause market interest rates to decline. Those lower interest rates would keep the expansion going and offset the otherwise contractionary effects of deficit reduction. And lower interest rates on the government deficit would substantially reduce the government's own interest outlays; each one percentage point decline in interest rates would save about $30 billion a year by the end of the current five-year budget period.

But reducing the budget deficit is not enough. Congress must takes steps to encourage more private saving. Our tax laws today discourage saving and encourage borrowing. A revenue neutral tax change could reverse this and provide an increased incentive to save and a decreased incentive to borrow.

Much of the inappropriate tax incentives result from the failure of our tax laws to recognize the difference between nominal interest rates and real inflation-adjusted interest rates. If I buy a Treasury bond, I receive a 9 percent interest rate. Since consumer prices are now rising at about a 5 percent rate, the real inflation-adjusted return is only 4 percent. Nevertheless, even with a 28 percent Federal tax rate and a 5 percent effective state tax rate, taxes take one-third of the nominal 9 percent return and leave me with an after tax return of only 6 percent. But subtracting the 5 percent inflation rate from this 6 percent net-of-tax return leaves me with a real net-of-tax return of only 1 percent!

In short, starting with a 4 percent real pretax return, I am left with only a 1 percent real after-tax return. Because our tax laws do not reflect the impact of inflation, the effective tax rate on real interest income today is 75 percent. No wonder the incentive to save is so low.

A similar thing happens when I borrow. I may pay 12 percent to borrow, but after subtracting inflation and taxes, the real net cost of borrowing is only 3 percent. No wonder I have a strong incentive to borrow.

The most direct approach to this problem would be to adjust interest income and payments for inflation. Even a rough and ready adjustment would provide a tax system which is fairer and which provides better saving incentives.

An alternative approach that would be desirable even if there were no distortion caused by inflation would be a revenue neutral package of tax changes aimed at increasing the incentive to save and reducing the incentive to borrow for consumption. Let me briefly mention some examples.

A large number of detailed studies indicate that IRAs are effective in encouraging increased private saving. The IRA changes in the 1986 Tax Reform Act not only denied the incentive to an important class of taxpayers but also has so confused the rules that many individuals who are eligible think that they are not. The IRAs should be restored.

But IRAs are not for everyone, especially for younger individuals for whom retirement seems too far away to contemplate. We should follow the lead of many other countries by having a more liquid type of tax-favored saving account that provides lower tax rates or full IRA treatment for funds that remain for several years. Alteratively, we could learn from the high-saving Japanese and have special low-tax-rate accounts and other enticements to save.

To pay for these pro-saving changes, Congress should end the anomaly of permitting taxpayers to deduct consumer interest as long as it is based on a home equity loan. It is hard to imagine a more unfair anti-saving provision. A multiyear phase out would prevent hardship for those who borrowed in anticipation of continuing to receive the tax deduction but still leave the Treasury with revenue to finance positive saving incentives.

This hearing is not the place for detailed tax reform proposals. But I want to conclude with this emphasis on the need to raise private saving as well as to reduce the Federal deficit as you work in the coming year to restore our national rate of saving.

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CRS REPORT FOR CONGRESS

**THE GROWING U.S. EXTERNAL DEBT:
NATURE AND IMPLICATIONS**

In 1985, the United States reverted to the position of being a net international debtor, a circumstance it had not been in since 1917. If trends continue, our external debt obligation could easily approach $1 trillion dollars before the mid-1990s. This report considers several questions and issues related to our debtor status. First, what is meant by the United States being a debtor nation: how is it measured, and what problems in measurement may exist? Second, what is the probable ultimate size of our external debt obligations; what forces will govern this size and what role can economic policy play? Finally, what are the economic implications of our growing foreign indebtedness: are there sizable risks attached to external sources of finance; what degree of debt service burden will the United States have to face in future years?

THE GROWING U.S. EXTERNAL DEBT:
NATURE AND IMPLICATIONS

In 1985, the United States reverted to the position of being a net international debtor, a circumstance it had not been in since 1917. The transformation was quick, taking less than four years to go from being the world's largest creditor to the largest debtor. More importantly, if trends continue, our external debt obligation could easily approach $1 trillion sometime in the 1990s.

This report will consider several questions and issues related to our debtor status. First, it is worth examining more closely what is meant by the United States being a debtor nation: how is it measured, and what problems in measurement may exist? Second, what is the probable ultimate size of our external debt obligations; what forces will govern this size and what role can economic policy play? Finally, what are the economic implications of our growing foreign indebtedness: are there sizable risks attached to external sources of finance; what degree of debt service burden will the United States have to face in future years?

TABLE 1. International Investment Position of the United States: 1975-1986
($ billions, at yearend)

	All Investment a/			Direct Investment			Corporate Equity			Debt Holdings		
	Assets	Liabilities	Net b/	Assets	Liabilities	Net b/	Assets	Liabilities	Net b/	Assets	Liabilities	Net b/
1975	295	221	74	124	28	96	10	36	-26	150	158	-8
1976	347	264	84	137	31	106	10	43	-34	189	190	-1
1977	379	306	73	146	35	111	10	40	-30	211	232	-21
1978	448	372	76	163	43	120	11	42	-31	262	287	-25
1979	511	416	95	188	55	133	15	48	-34	297	313	-17
1980	607	501	106	215	83	132	19	65	-45	361	353	8
1981	720	579	111	228	109	120	18	65	-47	463	406	57
1982	825	689	137	208	125	83	19	76	-47	587	487	100
1983	874	784	90	207	137	70	26	96	-70	629	551	78
1984	898	894	4	211	165	46	27	95	-68	646	633	13
1985	949	1,061	-112	230	185	45	40	124	-84	669	753	-84
1986	1,068	1,331	-263	260	209	51	51	167	-116	746	955	-209

a/ Official gold holdings of about $11 billion are included in total assets for each year.

b/ Due to rounding, differences between assets and liabilities are not always equal.

Source: Survey of Current Business, U.S. Department of Commerce, various issues.

THE U.S. INTERNATIONAL INVESTMENT POSITION

When it is said that the United States has been transformed from a creditor to a debtor nation, what is being observed is a change in the United States net international investment position. That position is a balance sheet measure of the difference between our accumulated stocks of foreign assets and foreign liabilities. Assets and liabilities in this balance sheet fall into three broad classes: direct investment, equity investments, and debt investments. Direct investment is the acquisition of new or existing facilities in a foreign country. If Honda Motor Co. builds an automobile plant in the United States that would be foreign direct investment in the United States and be entered as a liability in the net international investment balance sheet. Purchases of equity or debt are portfolio investments involving financial assets rather than real capital. If West German investors purchase quantities of IBM stock, they are making an equity investment; if they purchase U.S. Treasury bonds, they are making a debt investment. In either case, the purchase is recorded as a liability in the international investment balance sheet of the United States.

Table 1 reveals the recent record for the United States net international investment position. As recently as 1981, the United States was a net creditor to the rest of the world, with a net asset accumulation of $111 billion; in absolute size, this was a historical high, but only represented a modest 3.6 percent of GNP. Four years later, in 1985, we had become a large net debtor, in the sense that the value of our liabilities to the rest of the world was $112 billion greater than the value of our assets in the rest of the world. This process continued in 1986, bringing our accumulated net external obligations to $263 billion, or about 6.2 percent of GNP. As will be discussed more fully in the next section, this net accumulation of foreign financial obligations will grow in absolute size and as a share of GNP in 1987, and most likely for several more years into the future.

The deterioration in U.S. net international investment position occurred in each of the three investment categories. Net direct investment remained positive, but since 1981 has been sharply reduced by an $80 billion increase in foreign direct investment in the United States. Since 1981, U.S. equity and debt investments in the rest of the world continued to grow, but they were far outpaced by an inflow of foreign funds. The stock of foreign equity investments in the U.S. went from $65 billion to $126 billion and debt liabilities went from $406 billion to $751 billion.

It is not just a matter of semantics that we distinguish between these three sources of our "debtor" status. Direct investment and equity investments are very likely to be different in risk and return than debt instruments, and these differences can certainly affect the total size of the servicing costs of our external obligations. Although direct investment and equity holdings are most often thought of as U.S. liabilities, in a sense this is not true. They do represent claims on wealth within our national borders, but they do not carry a predictable debt service obligation for the United States as do foreign holdings of debt. Profits and dividends repatriated will influence capital flows and the balance of payments, but their contributions (unlike debt holdings) may be negative as well as positive.

Debt instruments, on the other hand, do not have to incur losses or reduced earnings. Their payment is an obligation that must be paid regardless

of economic circumstance. The only risk a debt holder incurs is that of default, when the debtor fails to meet the obligation to pay interest or repay principle.

The critical point being made here is that, while on a net international investment basis the United States now finds its foreign liabilities exceeding its foreign assets, only a portion of this change is the result of an increase in foreign holdings of our debt that carries a certain obligation to pay foreigners. In this regard, the recent large accumulation by the United States of foreign financial obligations is very much different than the "debt crisis" that several LDCs have faced in recent years where their obligations were almost exclusively of true debt instruments carrying a clear obligation to pay regardless of economic circumstances.

Measurement and Valuation Problems

There are good reasons to doubt the accuracy of the reported net international investment figures. U.S. assets are undervalued because direct investment assets and U.S. official gold holdings are carried at book, not market value. On the other side of the ledger, however, our liabilities may also be understated. Many economists believe that since 1978 the Commerce Department has been understating capital inflows to the United States. These unrecorded capital flows, it is pointed out, are showing up as the steady and sizable "statistical discrepancy" that has been recorded since that year. The cumulative effect of this understatement, if correct, could conceivably add close to $200 billion to the liability side of our net international investment position. Many analysts, however, think that an adjustment of that size would greatly overstate the effect of unrecorded capital flows. In their view, it seems likely that a sizable portion of the "statistical discrepancy" is the consequence of an overestimation of the United States current account deficit. An important observation is that the sum of the current account balances of all trading countries adds up to a large trade deficit worldwide. Moreover, it is thought that an important source of this discrepancy is derived from the underestimation of flows of service exports. This suggests that the United States -- the world's largest service-exporting economy -- may be undervaluing its service exports and thereby significantly understating its services surplus, and commensurably overstating its overall current account deficit. Correcting that measurement error would reduce the size of the net capital inflow and the attendant accumulation of foreign liabilities.

It is uncertain whether correction of all these measurement errors would improve or worsen our net international investment position. What is clear and not likely to be altered by correction of measurement error or changes in valuation is that the direction and magnitude of change in our net international investment position is toward an increased deficit. In recent years, America's net position in direct investment, corporate equity, and debt obligations have all worsened rapidly and will likely continue to do so for several more years. Whether we actually became a net debtor in 1983 or not until 1987 is largely irrelevant. The direction and magnitude of the forces now at work make it almost inevitable that if we are not now a debtor nation, we soon will be. The more interesting questions are the likely ultimate magnitude of our external debt and the economic implications of depending on and servicing large quantities of foreign financing of domestic economic activity.

FORCES GOVERNING THE GROWTH OF U.S. EXTERNAL DEBT

Our rapidly growing external debt is the result of large annual net inflows of foreign financial capital (direct investment, equity investment, and debt instruments) that have occurred for the last six years. Stop that inflow of capital and U.S. external debt will stop growing. While international capital is highly mobile and capable of fairly quick changes in its direction of flow, there is now an important constraint on how quickly the inflow of foreign capital can be turned around, namely, the United States current account deficit. That deficit, a net inflow of goods and services, is the real or goods and services counterpart to the net inflow of financial capital. The net inflow of capital provides us with the means (i.e., the foreign exchange) to purchase an equal size net inflow of foreign goods and services — the United States trade deficit. The inflow of capital is financing the current account deficit. Because this flow of goods and services (exports and imports) will change relatively slowly, it limits how quickly the financial inflow can ebb, and in turn how quickly our accumulation of external debt obligations will be stopped. It is certainly possible for changes in macroeconomic policy to hasten the speed of adjustment, but it will still involve a period of years under the best of circumstances.

Capital Flows and the Trade Deficit

It is perhaps useful to briefly explain the interrelationship between capital flows and the trade deficit. Today financial capital is highly mobile and flows relatively easily among nations, particularly industrial nations. Those capital flows are not random, however, but in large measure move in response to differences in expected rates of return among economies. Thus, we can expect a high interest rate nation to attract inflows of funds and low interest rate nations to experience outflows of funds, other factors being the same.

International capital flows will, however, affect exchange rates and, as a further consequence, trade balances. Nations that receive net inflows of foreign capital will have their currencies' exchange rate rise and trade balance turn to deficit; while economies that have net capital outflows will have their currencies depreciate and trade balance turn to surplus.

These relationships are easily explained. For a foreigner to buy an American asset that is denominated in dollars, he must convert his local currency to dollars. That transaction increases the demand for dollars and pushes up the dollar's price in terms of foreign currency -- the dollar's exchange rate rises. But, of course, as the exchange rate rises, the price of U.S. exports in world markets rises, the price of foreign goods in the U.S. market falls, and, as we would expect, U.S. exports decline, imports increase, and the trade balance moves toward a larger deficit (or a smaller surplus). Since the foreign funds can only be used to buy foreign goods, a net inflow of foreign capital must be matched by an equal sized net inflow of foreign goods -- a trade deficit. The exchange rate rises by what ever amount is necessary to assure this equivalence.

For the United States, high domestic interest rates attracted a net annual inflow of foreign capital peaking at about $150 billion. It was necessary

for the dollar to rise about 50 percent to ultimately induce a current account deficit of about $150 billion in 1986.

The question might be asked why were interest rates so high in the United States relative to those prevailing in the rest of the world. The answer to that question points towards the fundamental cause of capital and trade flows world-wide: savings-investment balances.

An economy whose flow of savings falls below its current investment needs will likely see domestic interest rates rise. If higher interest rates do not attract foreign capital to augment domestic savings, then domestic investment will likely fall to bring savings and investment into balance. If higher rates do attract foreign capital to augment domestic savings, then the level of domestic investment can be maintained, but, through the effects of a rising exchange rate, will cause activity in the tradeable goods sectors to suffer.

Table 2 clearly points out that, in recent years, the United States has experienced a substantial reduction in its rate of national savings relative to its rate of investment. Inflows of foreign capital (foreign savings) filled the gap, but with the attendant consequence of generating a large trade deficit. As we have already seen, that inflow of foreign savings and the trade deficit have led to the rapid accumulation of external debt obligations and the quick deterioration of our net international investment position. The counterpart to a deficiency of national savings in the United States has been significant excesses of domestic savings relative to domestic investment among our principal trading partners such as Japan, West Germany, and Canada. These nations are capital exporters, having to find foreign uses for their surpluses of domestic savings. These capital outflows, of course, have also meant that these nations have had equally large net outflows of goods — trade surpluses.

The principal source of the divergent behavior of national savings-investment balances has been recent trends in macroeconomic policy. Most importantly for the United States, Federal fiscal policy turned toward the running of large budget deficits in the early 1980s and those large deficits persist to the present. U.S. Government borrowing (often called Government dissaving) absorbed a large portion of domestic savings; and no offsetting increase in private savings occurred. In fact, quite the opposite seems to have occurred. For reasons that are not fully understood, the rate of private savings has dipped moderately in this period, contributing to the imbalance of domestic savings and investment. When we address the task of correcting this imbalance, however, we should remember that we know with great confidence what must be done to reduce Government dissavings, but remain most unconfident about how to increase private savings.

TABLE 2. Savings Investment and the Current Account Balance as a Percentage of GNP 1975-86

	Gross Domestic Private Savings	Gross Domestic Private Investment	General Government Budget* Balance	Savings-Investment Balance**	Current Account Balance
1975	18.9	13.7	-4.1	1.1	1.2
1976	18.0	15.6	-2.2	0.2	0.2
1977	17.8	17.3	-1.0	-0.5	-0.7
1978	18.2	18.5	0.0	-0.3	-0.7
1979	17.8	18.1	0.5	0.2	-0.0
1980	17.5	16.0	-1.3	0.2	0.1
1981	18.0	16.9	-1.0	0.1	0.2
1982	17.6	14.1	-3.5	0.0	-0.3
1983	17.4	14.7	-3.8	-1.1	-1.4
1984	17.9	17.6	-2.7	-2.4	-2.3
1985	17.2	16.5	-3.4	-2.7	-2.9
1986	16.0	15.8	-3.4	-3.2	-3.3

* Includes combined budgets of State, local, and Federal Governments.

** The savings-investment balance equals gross domestic savings minus gross domestic private investment plus general government budget balance.

Source: U.S. Department of Commerce. Survey of Current Business.

Over this period, quite opposite macroeconomic policies were being pursued by many of our principal trading partners, reinforcing the macroeconomic forces at work in the United States. The general tendency abroad was a move toward more fiscal restraint, aimed at reducing what were thought to be imprudently large government budget deficits. This action of course reduced demands on the domestic savings in these nations, which in many cases are already high relative to domestic investment needs. These policy actions worked to increase the flow of capital out of these countries, and exacerbated the flow of capital into the high-interest-rate U.S. economy.

This is a retelling of a widely accepted explanation of the sudden and rapid growth of our appetite for foreign borrowing and the rest of the world's increasing willingness to lend to the United States. More apropos to our current concerns, it makes clear what must occur to reduce that appetite and to stem the growth of external debt: U.S. domestic savings and investment must be brought into balance. Either our rate of domestic savings must rise or the U.S. rate of investment must fall.

Many economists argue that the most prudent path is to raise the U.S. national savings rate. To take the other path and reduce investment would be a move sure to undercut productivity and future advances in the U.S. standard of living. If we also consider that most evidence indicates that it is unlikely

the Federal budget deficit (perhaps going as far as to generate a budget surplus) would seem the most efficient route to increasing national savings, restoring a healthy balance between domestic savings and investment, and curtailing the growth of foreign indebtedness.

One should be clear, however, on the adjustment process likely to be involved. At this time, foreign investors are already attempting to stem their exposure to dollar-denominated assets. Even a rich nation such as the United States can not expect to continue to increase its foreign indebtedness without limit. Prudent foreign portfolio investors, faced with the increased risk of exchange rate induced capital losses for what are now relatively slight or nonexistent interest yield advantages, have attempted to limit or reduce their holding of dollar-denominated assets. The consequence of these actions has been that the dollar has fallen substantially already on foreign exchange markets and can be expected to fall even further. In response, we can expect to see the United States trade deficit shrink, but so will the supply of foreign funds. Therefore, if this inevitable reduction in our external deficit occurs without equal concurrent reductions in our Government budget deficit, domestic investment must fall to maintain balance with total national savings. If, however, the budget deficit is reduced in tandem with the trade deficit, domestic savings will rise (or we could say that Federal dissaving will fall) to offset the fall of foreign savings (the capital inflow), avoiding the need for a reduction of domestic investment.

The critical point being made here is this: regardless of any policy adjustment in the United States, foreign investors pursuing their own self-interest will steadily reduce the net inflow of foreign capital to the United States. This will mean that the trade deficit should vanish and our net foreign debt should stop growing. Policy adjustment in the United States can perhaps speed the pace of adjustment limiting the ultimate size of our external debt; and it can certainly influence the terms of adjustment, limiting the upward pressure on domestic interest rates and associated dampening effects on domestic investment.

LIKELY SIZE AND IMPLICATIONS OF OUR EXTERNAL DEBT

As pointed out above, the ultimate size of our net foreign indebtedness depends on the size and duration of our current account deficit. So long as we run a current account deficit, our stock of foreign liabilities grows and, of course, the larger those deficits are, the more rapidly those liabilities grow. While many economists are in agreement that our trade deficit is headed down, they also agree that the gap will be closed slowly. Consider the projections for the U.S. current account by several economic forecasters found in table 3. Even the most optimistic forecast seen there suggests that the current account deficit would not likely be below $100 billion by 1990. At this pace, the accumulation of liabilities to foreigners would leave the United States with a net debtor position of nearly $700 billion by 1990 and, depending on how rapidly the remaining current account deficit could be brought to zero, that number could certainly approach $1 trillion by the mid-1990s.

There are two major economic implications of the United States accumulating stock of foreign debt: (1) That debt must be serviced, necessitating an outflow of income and output to the rest of the world. This outflow may limit the rise in the standard of living of future Americans; (2) The continuing

reliance on substantial foreign financing may increase the exposure of our economy to destabilizing forces, and increase the risk of recession.

TABLE 3. U.S. Current Account Balance Forecasts
(billions of dollars)

	1987	1988	1989	1990
Data Resources, Inc.	-141.7	-131.0	-115.4	n.a.
Wharton Econometrics	-151.1	-156.2	-142.7	-136.3
Organization for Economic Co-operation and Development	-147.3	-125.8	n.a.	n.a.
Morgan Guaranty Trust Company	-145	-135	-120	-157

Sources: Data Resources, Inc. Review of the U.S. Economy. July 1987; Wharton Econometrics, U.S. Economic Outlook, 1978-89. August 1987; Organization for Economic Co-operation and Development. OECD Economic Outlook. June 1987; Morgan Guaranty Trust Company of New York. World Financial Markets. February/March 1987. A fuller discussion of trade statistics, including their recent behavior and prospects can be found in U.S. Library of Congress. Congressional Research Service. Trade and Current Account Balances: Statistics. Issue Brief No. IB87112, by Glennon J. Harrison. Washington, 1987.

Does Our Foreign Debt Impose a Burden in Future Generations?

Borrowing from abroad has allowed the United States to live beyond its means. Our large trade deficits indicate that, as a society, our demand for goods and services has exceeded our domestic supply. Foreigners have been willing to lend us the means to fill that gap with goods and services they have produced. As already discussed, this process cannot go on indefinitely, and that lending will dwindle. At that point, the United States will face the prospect of meeting the full payment obligations of the liabilities we have accumulated. Then, a stream of income and output will flow from the United States to the rest of the world. We will have to run a trade surplus to earn the foreign exchange needed to meet this obligation. That trade surplus is a measure of the goods and services we have produced but which are not available for our own use, but rather are meeting the demands of foreigners.

Whether that net outflow of goods and services would represent a decrement to the living-standards of future generations will depend on whether the United States used its foreign borrowing to support consumption or investment. If the United States used those funds to support current consumption, then living better today must come at the price of giving up some of our future living-standards. On the other hand, if we used foreign funds to support added investment in productive capacity, allowing the United States to increase its rate of producing goods and services, then it is possible that the United States could generate the trade surplus, (i.e., a net outflow of current production) to earn the foreign exchange needed to pay our foreign obligations, but not reduce the volume of goods and services available for domestic use (the measure of our living-standard).

There is no evidence, however, that our foreign borrowing augmented domestic investment. Table 2 above presented data on gross domestic capital

formation (the rate of private investment) as a percent of GDP. It is evident from that data that there occurred no increase in the average rate of private capital formation over 1980-1986, the period of large inflows of foreign capital. In 1984, 1985, and 1986, years of our greatest foreign borrowing, domestic investment was between 17 and 18 percent of GDP, essentially the rate that has prevailed in non-recession years, for the last 25 years. This suggests that the private sector has not used foreign borrowing to augment the U.S. economy's productive capacity.

Some make the argument, however, that while the private economy was not using borrowed foreign funds to support additional capital formation, the public sector was. It is certainly true that the Government makes expenditures that directly or indirectly increase the economy's productive capacity. Whether for infrastructure, research and development, aid to education, or even national defense, these types of expenditures may certainly increase or preserve the capacity of our economy to produce output. Unfortunately, the data do not suggest that our foreign borrowing greatly increased public investment. Table 4 shows the recent behavior of government consumption and investment spending as a percent of GDP. This series represents spending by all levels of government (Federal, State, and local) exclusive of transfer payments. Both consumption and investment expenditures are shown to address the concern that because of accounting conventions some types of government "investment" may be categorized as consumption. As can be seen, both series are trendless. Government expenditures have been essentially at the 18 percent of GDP level that has prevailed for the last 20 years. The same story emerges for expenditures by general government on capital formation with that type of expenditures remaining steady within a range of 1.0 percent to 1.5 percent of GDP.

TABLE 4. U.S. Federal, State and Local Government Consumption and Investmen as a Percent of GDP 1975-1985

	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
Consumption	18.6	18.1	17.6	17.0	17.0	17.6	17.5	18.4	18.4	18.0	18.3
Investment	1.8	1.4	1.2	1.5	1.3	1.3	1.1	1.3	1.2	1.2	1.4

Source: OECD. Economic Outlook, December 1986.

While the data in table 4 are thought by most analysts a reasonably accurate depiction of public investment trends in the U.S. economy, the case is made by some that these data fail to pick up an important increase in "true" public investment -- namely, a significant increase in spending for national defense. Such expenditures are by accounting convention measured as government consumption. Nevertheless, they are often of a form like other capital assets, being long-lived and conferring a stream of benefits for many years into the future. But do they enhance our economy's productive capacity? Not directly, but they can be viewed as a necessary prerequisite to ensuring our future economic growth and well-being.

The issue of whether defense expenditures should be viewed as public investment or consumption will not be resolved here. If one is inclined toward seeing them as investment, then several further points of qualification should be considered. First, we have borrowed far more from abroad than was needed to fund the increase in defense expenditures. Between 1980 and 1986, defense spending increased its share from 5.2 percent to 6.6 percent of GNP. This gain of 1.4 percent must be measured against an annual net inflow of foreign capital that has averaged the equivalent of over 3 percent of GNP in recent years. Second, not all of the increases in defense expenditures can be easily categorized as public investments. Procuring ships, airplanes, and other types of long-lived military hardware may indeed be true public investments, but the case for such categorization may be far less convincing for increases in expenditures on personnel or operations and maintenance. These may best be categorized as public consumption. Finally, we must also consider that while some portion of recent increases in defense spending may be public investment, those increases came at he expense of reduced non-defense expenditures. (As you can see in table 4, total government consumption expenditures did not rise.) One can easily imagine that some portion of these non-defense spending cuts, in a more accurate accounting framework, could also be categorized as true public investments. For example, spending on health and education could be reasonably judged to preserve and augment the economy's stock of human capital, clearly also a critical force behind economic growth. If this is the case, then one form of public investment has increased at the expense of another form, leaving in doubt whether there was in fact any substantial unmeasured increase in total public investment.

One is left with the conclusion that the lion's share of the substantial net inflow of foreign funds in recent years has not been used to support an above-normal expansion of the U.S. economy's productive capacity. Thus, the servicing of our debt obligations in years to come will come at the expense of future consumption of goods and services, and thus the standard of living of future generations.

The Size and Significance of Our Future Debt Service Burden

What needs to be considered now is the approximate size of our future debt service burden: What will be the size of the drain on the U.S. standard of living? Earlier in this discussion we observed that, based on a survey of forecasts of the current account deficit, the U.S. external obligation (the U.S. negative net international investment position) would easily accumulate to over $700 billion by the end of this decade and perhaps go a good deal higher if the pace of reduction for what still remained of the trade deficit was slow. For the sake of discussion, let's make the moderately pessimistic assumption that the U.S. net debtor position peaks at $1 trillion in the early 1990s. If we make the further reasonable assumption that the average interest rate (or rate of return) that applies to these foreign obligations is about 7 percent, then the average debt service obligation would be $70 billion. Be mindful that in making this computation, we have treated U.S. net accumulation of foreign liabilities as if they were all <u>true</u> debt obligations requiring the payment of interest. As pointed out earlier, this need not be an accurate depiction. Dividends and profits from equity holdings and foreign direct investment might yield payment flows that are less than what the assumption of a 7 percent rate of return might imply, but they might also prove to be larger. Thus, an outflow equal to 7 percent of U.S. net accumulation of liabili-

ties is only a reasonable approximation of the flow of payments likely to be associated with a trillion dollar net liability in the U.S. international investment position.

To judge how substantial a burden debt service of $70 billion would be, it must be considered in relation to U.S. ability to pay. Gross National Product (GNP) is the appropriate measure of this. Of course, we need to compare U.S. debt service obligation in the 1990s with GNP in the 1990s and this will also require an estimate. In 1986, U.S. GNP totalled $4.2 trillion. If we assume that the economy grows on average about 6 percent per year (the approximate combination of 2.5 percent real growth and 3.5 percent inflation), then, by the middle of the next decade, GNP would be near $7 trillion. Thus, a $70 billion debt service burden would represent about 1 percent of GNP in that future period. That does not sound terribly large, particularly if compared to the experience of Brazil with debt service at about 5 percent of GNP, or more pointedly, Mexico, with an annual outflow near 10 percent of GNP.

That 1 percent of GNP takes on more significance, however, if you view the outflow as a decrement from each year's growth of GNP, or the ability to improve U.S. living standards. In this regard, we should consider increases in real GNP, that is, increases in the volume of goods and services available to U.S. consumers. We must also understand that it seems likely that the fall of the U.S. terms of trade (i.e., export prices relative to import prices) that will accompany the swing to a trade surplus will result in the real transfer of goods to the rest of the world equivalent to 1.0 percent of real GNP. Since real GNP growth averages between 2.0 percent to 3.0 percent in most years, an outflow of goods and services of 1.0 percent of GNP would represent the loss of a half to a third of a typical year's increase in real output. Thus, meeting future U.S. debt service obligations could cause a substantial slackening of the pace at which U.S. living standards could improve. Of course, this drag on our living standards grows in significance if real GNP growth is below average in the next decade. That outcome is likely if large Government budget deficits are not reduced in tandem with the trade deficit. A persistent large budget deficit in the face of a reduced flow of loanable funds from abroad would force higher domestic interest rates, reduce investment, and lower productivity growth.

It is also important to remember that continued economic growth will steadily increase GNP, but debt service expense will not. Therefore, this erosion of living standards will diminish. If we extrapolate 10 years further down the road, GNP would likely have grown to near $14 trillion. In that situation, a $70 billion debt service payment would have shrunk to about ½ percent of GNP, representing perhaps a fifth of a year's (real) growth — still a significant but substantially smaller and shrinking drain on living standards.

Foreign Debt and Increased Exposure to Adverse External Events

Another concern with U.S. reliance on large inflows of foreign capital is that the potential volatility of these flows could be destabilizing, and, in the worst case, trigger a recession. There is likely a speculative element to foreign capital flows. It is judged by some that the fear of the capital losses associated with a falling dollar exchange rate could set off a speculative surge by foreign investors to attempt to quickly and substantially reduce

their holding of dollar-denominated assets. If foreign supplies of capital start to move out of dollar-denominated assets at a faster rate than domestic demands for that capital are shrinking, U.S. interest rates will rise. The fear is that in such a speculative collapse of the dollar, the rise of interest rates could be sharp, perhaps as much as five percentage points. Such a rate jump would severely dampen a variety of interest-sensitive demands for things such as housing, consumer durables, and business investment, and, as a result, trigger a recession. The sharp fall of the dollar that would accompany this capital outflow would also put upward pressure on domestic prices and exacerbate the recessionary momentum, especially if the Federal Reserve attempts to resist this inflationary impulse with a restrictive monetary policy. In this "hard-landing" scenario, the stimulative effects of a lower exchange rate on foreign trade would not materialize quickly enough to offset the forces of economic decline. If severe, such a recession could easily cause a greater decline in U.S. living-standards than that might be caused by servicing our future debt obligations.

One should not consider this a highly probable outcome. The dollar has already fallen substantially and no speculative collapse has occurred. While there have been increases in interest rates, they have not been accompanied by sudden large decreases in interest-sensitive consumer and business demand and the stimulative effects of the lower dollar on our trade balance (in volume terms) have been adequate to offset the dampening effect of rising interest rates. Nevertheless, the dollar has apparently not reached bottom yet and a speculative collapse and a recession still remain possible outcomes. Thus, the question we might ask is whether this is a risk worth being exposed to any longer than necessary. This points to a prudently quick shrinking of the need for that flow of capital --the trade deficit.

Global Equity

A final issue raised by our large and growing external debt has to do with global economic equity. Some feel that, in a world of capital-starved poor economies, it is not appropriate for the world's richest nation to also be the world's largest net importer of capital. On the other hand, if the United States had not used these resources, it is not at all clear that they would have flowed to the capital-poor LDCs. Similarly, in the future, when the United States runs a trade surplus and is exporting capital, the greater part will be going to our creditors who are, for the most part, rich industrial nations.

SUMMARY AND CONCLUSIONS

Persistent large trade deficits have made the United States a debtor nation for the first time in fifty years. Removal of the trade deficit will stem the growth of or external obligations, but not likely before they have grown to perhaps $700 billion to $1 trillion. To earn the foreign exchange needed to service our accumulated foreign debt will require the United States to run a substantial trade surplus. Because the United States used its foreign borrowing to support consumption rather than investment, this net outflow of goods and services to the rest of the world will, for a while, significantly slow the future advancement of living standards in this country. It

is also the case that the ongoing reliance on perhaps volatile foreign capital supplies increases the Nation's exposure to a recession-generating shock.

Prudent policy actions to greatly reduce the U.S. Federal budget deficit can help speed the ongoing reduction of U.S. trade deficits and reduce the ultimate size of our external obligations. Such actions would assure that a shrinking supply of foreign capital does not elevate domestic interest rates, hurt domestic investment, or imperil future advances in productivity. An imprudent policy response would be to succumb to the temptation of using inflation to reduce the real value of U.S. foreign debt. The last 20 years demonstrated the great economic and social costs of inflation and of its ultimate cure -- recession.

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With Technical Corrections

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